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DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

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HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

NINETY-SIXTH CONGRESS

SECOND SESSION

TO CONSIDER THE ACTIONS OF THE DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

AND

S. 2927

TO PRESCRIBE AN INTEREST-RATE DIFFERENTIAL ON DEPOSITS AND ACCOUNTS IN INSURED BANKS AND SAVINGS INSTITUTIONS

AUGUST 5, 1980

Printed for the use of the
Committee on Banking, Housing, and Urban Affairs

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DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

TUESDAY, AUGUST 5, 1980

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 10 a.m., in room 5302, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Cranston, Morgan, Sarbanes, Mitchell, Garn, and Kassebaum.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

Unfortunately, we are going to have an erratic and interrupted session because we are going to have a vote on a cloture petition in a few minutes, but we have a number of very distinguished witnesses this morning and rather than delay the beginning of the hearing I thought we would go ahead and probably have to suspend for at least a few minutes and come back.

Today the committee is meeting to review the recent actions taken by the Depository Institutions Deregulation Committee and to obtain views on S. 2927 which would restrict any reduction of the interest rate differential on categories of deposits created after December 10, 1975.

We will have two panels. The first is composed of the members of the Depository Institutions Deregulation Committee. The second panel consists of representatives of the industry associations of the depository institutions directly affected by decisions made by the Deregulation Committee.

The Deregulation Committee was established by this Congress as part of Public Law 96-221. The directive given to this committee by the Congress says:

> The Deregulation Committee shall, by regulation, exercise the authorities transferred by section 203 to provide for the orderly phaseout and the ultimate elimination of the limitations on the maximum rates of interest and dividends which may be paid on deposits and accounts as rapidly as economic conditions warrant.

Now it is important to recognize that the legislation merely authorizes a reduction in rate ceilings if the Deregulation Committee determines that economic conditions so warrant. The act imposes no affirmative duty to reduce rate ceilings automatically in order to maintain some fixed relationship to market rates. And, in fact, the statute does not even define the term "market rates," leaving the committee the flexibility to do that.

There are three major decisions made by the Deregulation Committee that have caused considerable controversy and complaint:

First, the committee has proposed to ban premiums given to a depositor and to ban the use of finders fees.

Second, the committee established, without public comment, severe penalties for early withdrawal of time deposits which require in some cases that a part of the depositor's principle be lost to the depository institution. I have received lots of complaints on that as a matter of principle from both bankers and depositors.

Third, the committee established new rules for interest rate ceilings on 6-month money market certificates and the 30-month small saver certificate.

Let me say just a few things about these decisions. First, I have doubts about the wisdom of the premium ban. Second, I believe the exceedingly harsh early withdrawal penalties are unfair to savers and may cause them to seek greater liquidity than is available in the money market on a more permanent basis if the penalty is not relaxed to protect the principal. Third, I think that you acted within your authority when you established the new ceiling structure on the money market certificates.

The marketplace is far ahead of the depository institutions in providing savers with a realistic rate of return and it is your job to put those institutions in the best competitive position you can as soon as you can. If you do not move deposit interest ceilings toward market rates as soon as possible and ultimately eliminate them, the small savers of this country will continue to move their funds out of our depository institutions and into money market funds or other money market investments that pay a market rate of interest. The thrift institutions should be more worried about the competitive money market than they are about the one-fourth differential that separates them from banks.

I feel that some of the controversy about the recent decisions you have made could have been avoided if the implications of those decisions had been more fully recognized both by you and by your staffs. In several cases your decisions could have benefited from public comments before final action was taken. I hope that in the future public comments will be invited on all of your proposed changes in regulations.

In closing, I would note that almost all of the members of this committee have written to the Deregulation Committee at least once to comment on recent decisions (see p. 185). I think that such correspondence can be useful to you and commend my colleagues for their continued interest in the financial deregulation process. Senator Morgan.

OPENING STATEMENT OF SENATOR MORGAN

Senator **Morgan**. Mr. Chairman, I welcome the hearings that you have called to oversee the activities of the Depository Institutions Deregulation Committee. I have urged that such hearings be held in the light of the many actions taken by the Deregulation Committee in its first 5 months of operation and I note that the House Banking Committee has conducted already several days of hearings.

Oversight hearings are seen by some to be a long and dull process, but it is clear that reviewing the conduct of our regulatory bodies is a responsibility that the Congress cannot and should not avoid.

I share the concerns of many members of this committee about the actions taken and proposals made by the Deregulation Committee. I have made my concerns known to the committee and to the Congress.

First, a ban has been proposed on the use of premiums. The use of items of less than $5 or $10 in value to attract savings has been advocated as a cost effective means of encouraging savings. While I have mixed feelings about the premiums themselves, there is evidence to support the argument that they do the job.

Many of us have a concern about the use of finders fees to avoid interest ceilings, but I do think that the abuses surrounding premiums and finders fees merit a blanket prohibition on premiums. In addition, are we going to regulate every little facet of the business of banking and the financial community?

Second, I share the concerns of many in the Senate about the new rules for withdrawal penalties on time deposits. In the past, a penalty was assessed on a certain amount of interest.

Under the DIDC proposal, the penalty for early withdrawal could be deducted from principal if insufficient interest had accumulated. Again, I think we see another disincentive for savers.

By making the rules more complex and the instruments less liquid, savers are likely to turn to other forms of investment, especially the money market certificates.

Third, and of most interest to me, is the complex regulatory scheme worked out to govern the interest differential on money market and small saver certificates.

With the passage of title II of H.R. 4986 earlier this year, many of us hoped that the regulatory agencies would balance the competing financial interests and develop an orderly process to deregulating savings rates. Even the opponents of the bill, such as myself, hoped that the Regulation Q issue had been resolved; 60 days after going into operation, however, the DIDC has stirred up protests from bankers, savings and loan associations, homebuilders, realtors and premium manufacturers.

Let me read from the section of the bill on which all of us relied. I think the chairman already has, but I will read it again.

> It is the purpose of this title to provide for the orderly phaseout—orderly phaseout I emphasize—and ultimate elimination of the limitations on the maximum rates of interest and dividends which may be paid on deposits and accounts by depository institutions by extending the authority to impose such limitations for 6 years, subject to the specific standards designed to insure a phaseout of such limitations to market rates of interest.

This language applied to accounts created after 1975 and in particular to the popular money market and small saver certificates.

It appears that the DIDC ignored congressional suggestions for targeting rates, that ceilings should not be set above market rates and for providing annual reports assessing the impact on housing and the soundness of depository institutions.

Accusations have been made that the DIDC did not meet the requirements of the law when it conducted closed meetings in May.

No advance notice for public comments was provided regarding the May 28 meeting where the new rate schedules were put into final form.

The decisions regarding the interest rate differential have been of the greatest concern to me.

As we all know, the committee altered the existing scheme on money market certificates, retaining the differential of one quarter of 1 percent only within a narrow range when Treasury bills are between 7.5 and 8.5 percent. On the small saver certificate, the ceiling rate on payable interest by all institutions was set at 9.5 percent.

I think this was very confusing for a variety of reasons. I thought the DIDC was charged with deregulating interest ceilings over a period of time. Here they have appeared to make the entire picture more complex. Frankly, this does not bode well for other congressional efforts at deregulation, and certainly not for delegating much authority. If agencies can take a directive to deregulate and then under discretionary authority muddy the waters as in this case, then I am afraid that much of the efforts of the Congress will be wasted.

I do not think that anyone can describe the rate schedule created by the committee with its higher rates, narrow range where the differential applies, "minimum ceilings" and "exceptions" without a reference to a chart. By setting a range of interest rates, experience suggests that the lowest minimum rate will become the maximum paid, regardless of other market trends. Rates which might drop will not do so if higher rates are paid by others to secure funds.

In one area, the differential, I believe that we can bring about some certainty. Eight Senators have joined me in introducing S. 2927 which provides for an across-the-board phaseout of the differential on all accounts created after 1975 at a rate of five basis points a year. Accounts in existence before 1975 are already provided for in Public Law 96-221.

Let me be honest. My main concern has been housing and the salvation of the thrift industry. In the past, homebuilding has been the force leading us out of recession. In the current economic and financial situation, I'm not sure that this will be possible again. I believe that the determinations of the DIDC may impede the process.

Senator Chiles summarized the problem on the floor the other day—"For the first 4 months of this year, there has been a tremendous drop in acquired net new savings, down 93 percent—for savings and loans. On the lending side, only $18.4 billion was loaned for mortgage in the first 4 months of the year, making a 35-percent reduction from the same period last year.

I am concerned that the differential decision, along with other actions of the DIDC, may make the situation even more difficult for savings and loans and banks which desire to fund home building.

S. 2927 would be a move in the right direction. The bill does not affect the 6-year lifespan for rate control of title II and it does not affect the other purposes of the legislation. What it does is to bring order to the savings market and allow savings to be accumulated to support new housing, something we thought the committee was going to do in an orderly fashion.

While each group within the financial community may be dissatisfied with parts of S. 2927, I believe it can benefit all of them.

For the Congress, it provides a resolution to the nagging question of the differential once and for all.

For the Deregulation Committee, the bill removes the burden of having to pick and choose where and when to reduce or remove the differential, while not impacting the other powers of the committee.

For the banks, this bill represents an across-the-board reduction in the competitive edge they feel the S. & L.'s have, through an orderly process.

For the savings and loans, S. 2927 represents an orderly plan for eliminating the differential in a manner which allows them to develop the competitive tools which were afforded them or given to them in H.R. 4986. The committee apparently thought that all these other competitive tools had come about overnight.

For the housing market, I believe that this bill will remove some disincentives to savings and will increase the money available for home mortgages. While investors may benefit to a degree by the minimum ceilings and the complex formula adopted by the DIDC, neither our inflation nor our homebuilding problems will improve.

By enacting S. 2927, we will have a logical, systematic and predictable pattern for the conduct of savings rate deregulation. This bill ends the dispute between the various financial groups over the time, place, and manner of the deregulation of the savings differential.

As I indicated earlier, I have concerns about several items and I look forward to the testimony of the many distinguished witnesses that we have here today.

Thank you, Mr. Chairman. It's time to go and vote. We will take a recess until the chairman or somebody gets back.

[Recess.]

[A copy of S. 2927 follows:]

II

96TH CONGRESS
2D SESSION

S. 2927

To prescribe an interest-rate differential on deposits and accounts in insured banks and savings institutions.

IN THE SENATE OF THE UNITED STATES

JULY 2 (legislative day, JUNE 12), 1980

Mr. MORGAN (for himself, Mr. GARN, Mr. RIEGLE, Mr. CHILES, Mr. DOMENICI, and Mr. FORD) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To prescribe an interest-rate differential on deposits and accounts in insured banks and savings institutions.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled, That section 102 of Public Law 94-200 (12 U.S.C. 461 note) is amended—

(1) by inserting after subsection (a) the following:

"(b) With respect to any category of deposits or accounts established or authorized after December 10, 1975, an interest rate differential between (1) any bank (other than a savings bank) the deposits of which are insured by the Federal Deposit Insurance Corporation, and (2) any savings and loan, building and loan, or homestead association (including cooperative banks) the deposits or accounts of which are insured by the Federal Savings and Loan Insurance Corporation or any mutual savings bank as defined in section 3(f) of the Federal Deposit Insurance Act (12 U.S.C. 1813(j)), shall be established so that the maximum rate payable on such deposits or accounts by savings and loan associations and mutual savings banks described in clause (2) will exceed the maximum rate payable on such deposits or accounts by banks described in clause (1) by not less than 0.25 per centum per annum until June 30, 1981; by not less than 0.20 per centum per annum until June 30, 1982; by not less than 0.15 per centum per annum until June 30, 1983; by not less than 0.10 per centum per annum until June 30, 1984; and by not less than 0.05 per centum per annum until June 30, 1985.";

(2) by redesignating subsection (b) as subsection (c); and

(3) by inserting "or (b)" after "subsection (a)" in subsection (c) as redesignated.

○

The CHAIRMAN. The committee will come to order. I apologize for the delay, gentlemen. I understand that some of you may have statements and, Chairman Volcker, you being the Chairman of the DIDC, why don't you proceed and then allocate your time as you wish to the other panel participants. Go right ahead, sir.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. I am pleased to be here this morning on behalf of the Depository Institutions Deregulation Committee (DIDC) to discuss the actions taken by that committee in the months since its creation by the Depository Institutions Deregulation and Monetary Control Act of 1980.

At the outset, I would like to emphasize my personal view that the committee has worked effectively, with good coordination and cooperation among the constituent agencies that make up its membership. As might be expected, differences of opinion or emphasis on some issues have been expressed, but I have been much more impressed with the degree of consensus that has developed as we have attempted to solve common problems. The committee staff, drawing on the expertise of each agency, has provided a balanced analysis of the issues, so that discussion among the DIDC members has had a common base as well as drawing on the special insights of the individual members. Our discussions have focused—I believe in a balanced way—on the needs of savers and borrowers, the relationship between DIDC decisions and the pattern of economic growth, the needs of financial institutions within the context of a changing competitive environment, and the charge of Congress to the committee to look toward the eventual elimination of deposit rate ceilings. As this listing suggests, we see our central responsibility under the law as one of managing interest rate ceilings in a manner that supports the Nation's economic goals and prepares the way for ultimate deregulation; the controversial matter of the differential on various types of deposit instruments created after December 1975 should be evaluated in that larger context.

PREMIUMS AND FINDERS' FEES

The first major issue before the committee was that of premiums and finders' fees for new deposits. The issue had been under study by the various agencies and had already been scheduled for discussion by the Interagency Coordinating Committee when the DIDC was created. While the question of permitting or eliminating premiums of finders' fees is sometimes posed as an issue of further regulation rather than deregulation, that view seems to be oversimplified. The fact is that premiums and finders' fees have been regulated in large part as a means of enforcing deposit rate ceilings, but DIDC members have found that current industry practices involving the use of premiums and finders' fees are making i increasingly difficult to administer such ceilings fairly and effectively during the phaseout period. Regulatory limits on the value o gifts have been difficult to enforce, and it is evident those limitations are being widely exceeded in some instances. The effect is t increase yields above deposit rate ceilings and divert valuable examiner time that clearly could better be spent evaluating th safety and soundness of institutions. Offers of cash by some institutions to those that bring a "friend" to make a deposit have recently increased deposit yields by 1½ or more percentage points above ceiling rates in some markets; it is apparent that such finders' fees are often shared, directly or indirectly, with the depositor, contrary to the intent of present regulation.

An extended comment period on DIDC proposals to ban both premiums and finders' fees for any deposit subject to rate ceilings has resulted in widespread comment. These comments, along with other relevant material, are now being analyzed by our staff. Our present schedule calls for the DIDC to make its decision on September 9. In order to provide planning time for the industry, the committee has already announced that, should it take action on on would not be effective until December 31.

In its most significant decision, the DIDC at the end of May adjusted the ceiling rates payable on both 6- and 30-month floating ceiling deposits—those deposits whose ceiling rates are tied to interest rates on comparable maturity Treasury securities. Attachment I displays those ceilings before and after the recent action; floating rate deposit ceilings are relatively recent, first being introduced in mid-1978. The adjustments made increased the ceilings by changing their relationship to the corresponding Treasury securities yields and established minimum ceilings for each of the deposit categories.

Several factors led us to take these actions. With respect to increasing the ceilings relative to Treasury securities, the primary objective was to improve the competitive position of all depository institutions, in order to attract funds at a time when the extreme pressures on institutions' earnings seemed to be subsiding. Savings and loan associations, mutual savings banks, and smaller commercial banks—all of which had been under liquidity pressure—are a primary source of credit for housing, agriculture, and small business. These institutions had been finding it increasingly difficult to compete with alternative market instruments for funds, particularly money market mutual funds and Treasury securities. Attachment II shows these rate relationships. In that connection, I should note that yields on Treasury securities to which the deposit ceilings are related are typically significantly below other interest rates available in the market.

I believe all of the DIDC members are sensitive to the reality of an environment in which the cutting edge of competition faced by depository institutions has been increasingly not among themselves, but with nondeposit insttruments—and especially with new vehicles such as money market mutual funds. Funds diverted to the market or to money market funds do not directly find their way into important credit markets—especially for housing, agriculture, and small business—emphasized by the institutions. By allowing depository institutions the flexibility to offer higher returns, the changes made by the committee should facilitate a larger increase in their deposits and, consequently, the flow of funds to the credit markets they serve. Moreover, the overall decline in interest rates occurring at the time the actions were taken, by easing the earnings pressures faced by many of these institutions, made them better able to offer the more competitive rates. In short, from the point of view of both economic recovery and concern with the long-run financial strength and competitive posture of depository institutions, it seemed to the committee a desirable time for banks and thrifts to be placed in a stronger position to increase flows of small time deposits with floating ceilings.

The concept of minimum ceilings, which, at the time the decision was made, were at levels near or below those prevailing, was adopted in part in recognition of the fact that Treasury security yields are not only generally below other market rates but generally lead declines in other rates available to savers. Thus, floating deposit rate ceilings related to such instruments would decline more rapidly than yields on other available instruments, such as money market mutual funds. As a consequence, the competitive position of depository institutions might, at least temporarily, suffer should Treasury security yields, to which floating ceilings are tied, dip to relatively low levels. In an environment of declining interest rates, in which pressures on institutional earnings would in any event be reduced, the best approach seemed to be to permit the thrifts and small banks to compete more effectively.

In the past, declines in interest rates have been associated with an acceleration of deposit inflows to thrifts and small banks because their fixed rate ceiling deposits became increasingly more attractive relative to competitive instruments. Today, those fixed rate deposits are well below market rates. But establishment of a minimum ceiling rate on the popular 6- and 30-month floating ceiling certificates potentially enables depository institutions to enhance their competitive performance in a relatively low rate environment.

In addition, the congressional mandate to the DIDC to look toward ultimate removal of deposit rate ceilings suggested that it would be desirable for the depository institutions, when consistent with other goals, to gain experience with greater competitive freedom in rate setting. DIDC members are aware that there has been a tendency for institutions generally to pay the ceiling rate, and that consequently, institutions may be reluctant to follow open market rates down, should they drop appreciably. In the shortrun, at the minimum levels of the ceiling, the result should be higher inflows of deposits than would otherwise take place. Should rates in the open market persist at lower levels, institutions should in time respond; indeed, any other result would cast in doubt the concept of deregulation.

The question of a differential in deposit rates between thrifts and banks has, of course, been highly controversial. The DIDC left the one-quarter percent differential intact for 30-month savings certificates. Those longer term deposits are considered particularly appropriate to the longer term nature of thrift institutions' asset distribution, and provide a more solid base and incentive for mortgage lending.

NEW RATE CEILINGS

The DIDC, in establishing the new rate ceilings, also faced the prospect that the decline in interest rates would, under preexisting arrangements, reintroduce a differential on 6-month money market certificates after more than a year during which commercial banks and thrifts had competed on equal terms. Small commercial banks, which are significant lenders not only in the mortgage market, but also to agriculture and small businesses, could thus have faced substantial deposit attrition and significant pressure on their ability to extend credit to vulnerable sectors of the economy. In the light of that potential problem, the committee, while permitting the differential to reappear generally at levels of rates prevailing in recent months, also permitted commercial banks temporarily to reissue maturing MMC deposits to the same holder at a rate equal to the thrift ceiling. Moreover, the minimum deposit ceiling established made no allowance for a differential, mainly on the basis that should those minimums be effective, all institutions would be in a relatively favorable position to attract deposits.

In evaluating the potential impact of the late May deposit rate ceiling adjustments, DIDC members were apprehensive that lenders may not be willing to commit additional deposit inflows to mortgage and other credit markets because of their concern that those deposits would be rapidly withdrawn if market rates subsequently rose. In the environment of rising interest rates in late 1979 and early 1980, the volume of withdrawals prior to maturity for the purpose of acquiring higher yielding deposits—often at the same institution—rose sharply because the early withdrawal penalty in the early months of a deposit's life was not sufficient to offset the gain from reinvestment. Technically, this reflected the provision that the minimum required penalty was imposed only on accrued interest and did not require a reduction in the amount of the original deposit; in the early months of a deposit's life there is insufficient accrued interest to act as a deterrent to early withdrawal when interest rates are rising appreciably. In those circumstances, the original maturity of the deposit lost significance. Hence, in late May, the DIDC modified the early withdrawal rule to increase the early withdrawal penalty in the early months of a deposit's life, while leaving the penalty in subsequent months virtually unchanged; in the first months of the life of the deposit, the penalty will exceed accrued interest. While the committee is aware that the depositor who breaks his deposit contract by withdrawing the deposit prior to maturity may be concerned upon finding his principal reduced by early withdrawal penalties, a similar situation would also occur if an investor were to liquidate a market security prior to maturity in a rising rate environment. A depositor provided a market-oriented rate of return on a term deposit is, in effect, asked to share more of the interest rate risk formerly borne by the depository institution, a risk that appeared to be limiting the willingness of the institutions to commit funds to credit markets.

Attachment III reviews actual experience since the DIDC acted in late May. On a seasonally adjusted basis over the last two months, small time deposits—mostly MMC's and small saver certificates—at all institutions have shown only modest growth, but thrifts appear to have performed somewhat better than commercial banks. Both banks and thrifts have experienced outflows of MMC balances, as the ceiling rate on such deposits generally remained below those available on alternative investments, despite the ceiling rate adjustment—see attachment II. Both kinds of institutions have attracted larger inflows of 2½ years or longer small saver certificates, but thrifts, which have had the advantage of a 25-basis-point differential, have done relatively better. Presumably, growth in total small denomination time deposits at both sets of institutions would have been slower and even negative, without the DIDC actions of late May.

The biggest surprise has been the behavior of savings accounts, which rose substantially at all types of institutions in spite of ceiling rates well below market rates. Undoubtedly, economic uncertainty—including questions in depositors' minds about the interest rate outlook—has increased the public's desire to hold highly liquid assets. Although the increase in total time and savings deposits has not as yet been reflected in expanded mortgage holdings at the various institutions, both outstanding and new commitments by savings and loan associations registered increases in June.

EFFECT OF CEILINGS ON MORTGAGE RATES

Questions have arisen about the effects of the DIDC actions on mortgage rates. As a general principle, the effect of the ceilings on mortgage rates must be viewed in the context of the entire capital market, of which the mortgage market is just one part. Mortgage rates are unlikely for long to diverge substantially from other capital market rates because many potential mortgage buyers can shift freely from bonds to mortgages, or the reverse. However, to the extent that higher ceilings increase the ability of depository institutions to compete for deposit funds, the flow of mortgage credit should be enhanced, tending to bring downward pressure on mortgage rates relative to the bond market. Deposit costs can at times play some role in that process, but the current spread between mortgage rates and deposit costs appears wide enough to induce profitable mortgage lending should deposit inflows materialize in size, and that factor appears to have contributed to the recent tendency for mortgage rates to fall.

Finally, I would like to comment on S. 2927, a bill which would require a full 25 basic point differential on all deposit categories established after December 10, 1975, for 12 months, and then reduce the differential 5 basis points per year for the subsequent 5 years. The DIDC presently has the authority to institute a schedule such as that proposed in the bill for all such deposit categories and to create new deposit categories with or without the differential. However, my own feeling—reinforced by my actual experience in working with the committee—is that the public interest in the face of shifting and uncertain markets is likely to be enhanced by retaining flexibility within the overall context of working toward deregulation. I understand some other members of the committee may have a different view of this matter; the bill has not been discussed at a committee meeting.

[Attachments to statement follow:]

Attachment I

Ceiling Rates
on
6-Month Money Market Certificates 1/
and
30-Month Small Saver Certificates 2/

6-Month MMCs

Before May 28

When the 6-month bill rate is:	Commercial Banks May Pay	Thrifts May Pay
Above 9.00 percent	Bill rate	Bill rate
8.75 to 9.00 percent	Bill rate	9.00
Below 8.75 percent	Bill rate	Bill rate plus 25 basis points

After May 28

When the 6-month bill rate is:	Commercial Banks May Pay	Thrifts May Pay
8.75 percent & above	Bill rate plus 25 basis points	Bill rate plus 25 basis points
8.50 to 8.75	Bill rate plus 25 basis points	9.00
7.50 to 8.50	Bill rate plus 25 basis points	Bill rate plus 50 basis points
7.25 to 7.50	7.75	Bill rate plus 50 basis points
Below 7.25	7.75	7.75

30-Month SSCs

Before May 28

When the 2-1/2 year Treasury security yield is:	Commercial Banks May Pay	Thrifts May Pay
Above 12.50	11.75	12.00
12.50 and below	2-1/2 year bond rate minus 75 basis points	2-1/2 year bond rate minus 50 basis points

After May 28

When the 2-1/2 year Treasury security yield is:	Commercial Banks May Pay	Thrifts May Pay
Above 12.00	11.75	12.00
9.50 to 12.00	2-1/2 year bond rate minus 25 basis points	2-1/2 year bond rate
Below 9.50	9.25	9.50

1/ $10,000 minimum deposit.
2/ No regulatory minimum deposit.

Attachment II
Rates of Return on MMCs and Alternative Investments
(percent)

1980		6-month Treasury Bill Rate		Commercial Bank MMC Rates				Thrift MMC Rates				MMMF 1/ Average 7-day net yield	
				New Rule		Old Rule		New Rule		Old Rule			
Week Ending		Auction Rate	6-month Investment Yield	Nominal	Effective 2/	Nominal	Effective 2/	Nominal	Effective 2/	Nominal	Effective 2/	First Generation	Clones
April	2	15.70	18.04	--	--	15.70	16.55	--	--	15.75	16.55	15.04	--
	9	14.80	16.88	--	--	14.80	15.57	--	--	14.80	15.57	15.56	15.80
	16	14.23	16.15	--	--	14.23	14.95	--	--	14.23	14.95	16.03	17.00
	23	13.55	15.29	--	--	13.55	14.21	--	--	13.55	14.21	16.32	15.46
	30	11.89	13.24	--	--	11.89	12.42	--	--	11.89	12.42	16.03	13.90
May	7	10.79	11.91	--	--	10.79	11.24	--	--	10.79	11.24	15.52	11.89
	14	9.50	10.37	--	--	9.50	9.82	--	--	9.50	9.86	13.61	9.93
	21	8.78	9.54	--	--	8.78	9.10	--	--	9.00	9.33	12.72	10.06
	28	8.92	9.70	--	--	8.92	9.25	--	--	9.00	9.33	11.99	8.76
June	4	7.75	8.35	--	--	7.75	8.02	--	--	8.00	8.28	10.73	8.16
–	11	8.17	8.82	8.42	8.81	8.17	8.45	8.67	8.98	8.42	8.71	10.63	8.16
	18	6.94	7.42	7.75	8.01	6.94	7.16	7.75	8.01	7.17	7.42	9.79	7.76
	25	6.66	7.11	7.75	8.01	6.66	6.87	7.75	8.01	6.91	7.13	9.19	7.53
July	2	7.11	7.62	7.75	8.01	7.11	7.34	7.75	8.01	7.36	7.56	8.66	7.50
	9	8.10	8.74	8.35	8.64	8.10	8.38	8.60	8.91	8.35	8.64	8.82	7.83
	16	8.11	8.76	8.36	8.66	8.11	8.40	8.61	8.93	8.36	8.66	8.57	7.71
	23	8.11	8.76	8.36	8.66	8.11	8.39	8.61	8.92	8.36	8.66	8.43	7.50
	30	7.91	8.52	8.16	8.44	7.91	8.18	8.41	8.71	8.16	8.44	8.13	7.76
Aug.	6	8.28	8.95	8.53	8.83	8.28	8.57	8.78	9.10	8.53	8.83	n.a.	n.a.

* Footnotes on page 11.

Attachment II (Cont'd)

Rates of Return on 2-1/2 year-or-Longer Small Saver Certificates
(percent)

1980	Constant Maturity 2-1/2 Year Treasury Bond	Commercial Banks				Thrifts			
		New Rules 3/ 5/		Old Rules 4/ 5/		New Rules 3/ 5/		Old Rules 4/ 5/	
		Nominal	Effective	Nominal	Effective	Nominal	Effective	Nominal	Effective
Monthly									
January	10.90			10.15	10.84			10.40	11.12
February	11.15			10.40	11.12			10.65	11.40
March	14.00			11.75	12.65			12.00	12.94
April	14.65			11.75	12.65			12.00	12.94
May	11.25			10.50	11.23			10.75	11.51
2 Weeks Ending									
June 11	9.05	9.25	9.83	8.30	8.78	9.50	10.11	8.55	9.06
25	9.00	9.25	9.83	8.30	8.78	9.50	10.11	8.55	9.06
July 9	8.60	9.25	9.83	7.85	8.28	9.50	10.11	8.10	8.56
23	9.05	9.25	9.83	7.85	8.28	9.50	10.11	8.10	8.56
Aug. 6	9.05	9.25	9.83	8.30	8.78	9.50	10.11	8.55	9.06

1/ Includes any capital gains or losses.

2/ The effective rate assumes reinvestment of principal and interest at the same rate for another six months.

3/ Minimum ceiling rates of 9-1/2 percent at thrifts and 9-1/4 percent at banks are established.
Maximum rates set in March will continue.
Between the minimum and maximum rates payable, thrifts may pay the 2-1/2 year Treasury securities rate and banks may pay this rate less 1/4 of a percentage point.
The rate will change bi-weekly beginning Monday, June 2, based on average daily yields for the five business days ending every other Monday, and will be effective the following Thursday.
The temporary cap of 12 percent at thrifts and 11-3/4 percent at banks which was set in February 1980 remains in effect.

4/ Rate ceiling changed on first calendar day of each month, based on average 2-1/2 year yield on Treasury securities.
This yield was announced three business days prior to the first day of the month, and was based on the average daily yields for the preceding five business days.
Nominal ceilings at banks and thrifts were 3/4 and 1/2 of a percentage point, respectively, below the 2-1/2 year Treasury securities yield.

5/ The effective rate assumes continuous compounding on a 365/360 day basis.

Attachment III

Composition of Deposit Flows
(Seasonally adjusted, percentage annual rate of growth) 1/

	All Depository Institutions			Commercial Banks			Thrifts		
	Savings Deposits	Small Denomination Time Deposits	Total Savings & Small Time	Savings Deposits	Small Denomination Time Deposits	Total Savings & Small Time	Savings Deposits	Small Denomination Time Deposits	Total Savings & Small Time
1980--Jan.	-14.1	9.5	0.3	-12.4	22.3	6.6	-15.2	2.3	-3.8
Feb.	-25.1	17.4	1.1	-22.5	25.5	4.7	-27.7	12.5	-6.4
March	-33.6	29.0	5.5	-35.6	42.7	9.0	-31.7	20.8	3.1
April	-44.4	36.1	6.9	-43.3	54.5	14.1	-45.5	24.9	1.8
May	-14.9	17.1	6.0	-7.5	14.0	5.6	-21.3	19.0	6.3
June p/	25.8	2.3	10.3	32.9	-2.8	10.9	19.2	5.6	9.8
July (est.)	28.7	-0.5	9.6	38.0	-2.8	13.5	20.4	0.9	6.9

Memo: Flows in billion of dollars, not seasonally adjusted

	6-month MMCs		30-month SSCs		Sum of MMCs and SSCs	
	Commercial Banks	Thrifts	Commercial Banks	Thrifts	Commercial Banks	Thrifts
1980--April	19.3	17.0	2.8	7.2	22.1	24.2
May	-2.7	-5.6	4.6	9.1	1.9	3.5
June	-3.4	-5.2	4.2	6.3	0.8	1.1
July (1st 20 days)	n.a.	-4.9 2/	n.a.	4.7 2/	n.a.	-0.2 2/

1/ Commercial bank data are daily average and thrift data are average of month end.
2/ First 20 days for insured S&Ls only.
p/ Preliminary.

The **Chairman**. Chairman Volcker, again I apologize. Unfortunately, there's another rollcall and I'm going to have to run to the floor. This should be only one rollcall so I should be back in 10 minutes and we can resume.

[Recess.]

Senator **Morgan**. The chairman said he would be back at any moment and I understand Chairman Volcker has already made his statement and now we have Larry Connell, Chairman of the Board of the National Credit Union Administration. We're glad to have you and we would be glad to hear from you now.

STATEMENT OF LAWRENCE CONNELL, CHAIRMAN OF THE BOARD, NATIONAL CREDIT UNION ADMINISTRATION

Mr. **Connell**. Mr. Chairman, members of the committee I am pleased to be here today to comment on the actions of the Depository Institution Deregulation Committee.

As you know, Mr. Chairman, many of the matters being considered in this hearing are also the subject of a pending lawsuit filed by the U.S. League of Savings Associations against the DIDC. Therefore, while I find it incumbent upon me to address before this committee the issues of the suit, I must do so in a manner so as to not jeopardize the defense of that litigation.

I have reviewed the statement of Chairman Volcker which outlines the actions taken during the meetings of the DIDC as well as the rationale for such actions. This statement accurately reflects the activities of the committee and therefore I will not duplicate this information in my statements.

Instead, I am limiting my statement to a brief observation concerning the statutory directive to the DIDC, to some comments as to actions taken by NCUA, and comments on Senator Morgan's bill. However, I will be glad to address questions in all areas which the committee desires to explore.

The DIDC, created by title II of Public Law 96-221, has been given the mandate of insuring that all limitations on the maximum rates of interest and dividends which may be paid on deposits and accounts by depository institutions are eliminated no later than March 30, 1986. It is further mandated that this be accomplished by means of an orderly phaseout.

It is my opinion that the main difficulties being encountered by the committee, in what I regard as an extremely difficult assignment, center around the task of implementing this orderly phaseout. While there have certainly been differences of opinion as to what this term was intended to mean, I can simply assure the members of the committee that each member of the DIDC is diligently attempting to carry out the directives set forth in Public Law 96-221.

NCUA ACTIONS

Although not obligated by the provisions of Public Law 96-221, NCUA has attempted to parallel, wherever the structure of credit union accounts and operations permit, the actions taken by the DIDC. For example, following the first meeting of the DIDC, NCUA proposed a rule on grace periods for share certificates and on early withdrawal penalties and adopted a final rule on money market certificate grace periods. With respect to the matter of premiums, finders fees and payment of dividends in merchandise, we issue an advance notice of proposed rulemaking in which we sough comments on the extent to which the DIDC's proposed rule migh pertain to Federal credit unions.

One final area, Mr. Chairman, is that of share certificate NCUA has also adopted the general rate formula on certificates o deposit promulgated by the DIDC at its meeting of May 28, 1980 However, I must note for the record that the maturity structure o NCUA's certificate of deposit regulation has provided Federa credit unions with greater flexibility than DIDC regulations. Currently, Federal credit unions may offer certificates of deposit at a maximum rate of 9½ percent with maturities ranging from 3 months to 6 years at the option of the credit union.

S. 2927

Mr. Chairman, your letter of invitation to testify requested comments on Senator Morgan's bill, S. 2927. This bill would bring accounts established after December 10, 1975, under the provisions of Public Law 94-200 and would provide for the establishment of a one-quarter percent differential on these newer accounts. These accounts would retain this newly established differential for 1 year at which time it would be phased out at the rate of five basis points per year. The provisions regarding the differential on accounts established prior to December 10, 1975, would remain unchanged; namely, that in order to reduce the differential on passbook savings, Congress must receive written notification from the Federal Reserve and by concurrent resolution approve the proposal contained in the notification.

I believe that the approach taken in S. 2927 is too rigid and somewhat complex in that it does not apply to all types of accounts. The advantage to the phaseout being accomplished by the DIDC is that the schedule can be adjusted to meet changing economic conditions. I would urge that we do not change at this time.

Mr. Chairman, this conculdes my testimony. I will be glad to answer any questions which the committee might have.

Senator MORGAN. Thank you, Mr. Connell. We will proceed to hear from Mr. Jay Janis, Chairman of the Federal Home Loan Bank Board.

STATEMENT OF JAY JANIS, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD

Mr. JANIS. Mr. Chairman, members of the committee, thank you for asking me to appear today to testify concerning the Depository Institutions Deregulation Committee. As you know, Public Law 96-221 provides that, as Chairman of the Federal Home Loan Bank Board, I serve as a member of the DIDC individually, rather than as spokesman for our agency. While your invitation, in effect, requested me to come wearing my hat as a DIDC member, I have circulated copies of my remarks to Mr. Dalton and Mr. DiPrete. Since they agree with my views, you may consider my prepared statement as expressing the opinion of the Bank Board.

At the outset, I would like to to make it very clear that the Bank Board continues to support the gradual phasing out of rate controls as provided in the Depository Institutions Deregulation and Monetary Control Act of 1980.

CLARIFYING DECONTROL PROCESS

In the Bank Board's opinion, however, the DIDC is very much in need of clarifying guidance from Congress regarding one particular aspect of the decontrol process. I am referring, of course, to the status of the differential during the phaseout period. In passing the Deregulation Act, Congress clearly preserved the existence of the differential on account categories existing as of December 10, 1975. For other categories, however, which we expect to be increasingly significant in the years to come, the existence of a differential is a matter within the complete discretion of the DIDC, subject, of course, to the need to act consistently with congressional intent.

This intent, however, is not completely clear to all concerned. Since the question of the extent to which the differential will continue during the rate control phaseout period is one of enormous significance to the thrift and housing industries, we believe it is necessary that Congress give the DIDC clear and precise guidance on this point.

The importance of the differential to housing is irrefutable; it provides the thrift industry with a vital tool for attracting the savings dollars which supply mortgage financing for housing. This tool has been of great importance to thrift institutions over the past 14 years because of the increasingly intense competition for savings that they have been experiencing from commercial banks. Commercial banks have enjoyed a critical competitive advantage in the battle for savings in that they long have been able to offer a wide array of "one-stop" services that allow customers to take care of all their financial needs at one location.

Thanks to Public Law 96-221, of course, Federal S. & L.'s now have the statutory authority to function similarly as "one-stop" centers for customers seeking family financial services, although we in no way expect the new powers conferred by Congress to cause thrifts to abandon their role as the Nation's major mortgage lenders. Without downplaying the very obvious importance of authority in Public Law 96-221, however, I must stress that the mere fact that the necessary laws are on the books for Federal S. & L.'s does not mean that all thrifts suddenly are capable of competing effectively with commercial banks in the absence of significant assistance from the differential.

This assistance will be required until the thrift industry's new asset and liability powers are actually in use to a degree sufficient to enable thrifts to compete with banks. The Bank Board remains confident that NOW accounts, consumer lending and other authority provided by Public Law 96-221 will make termination of the differential possible on a nondisruptive basis as part of the general phaseout of rate control. But, we are equally confident that undercutting the usefulness of this tool before the beneficial effects of the new powers actually are being realized would be a grave mistake. By reducing the thrift industry's ability to compete for savings, such a step could significantly reduce the volume of funds available for mortgage lending during a decade that is expected to be characterized by extraordinary housing demand.

Accordingly, in order to avoid the possibility that unnecessary shocks could be administered to the thrift industry and housing during the dismantling of rate controls, the Bank Board urges that Congress make its intent clear that, while the decontrol process is ongoing, thrift institutions will have the advantage of a differential on account categories established subsequent to December 10, 1975. We believe it is highly likely that the DIDC will be creating new account categories in the phaseout period, and that these, combined with existing post-1975 categories, will come to represent the most significant proportion of thrift deposits. If the differential is to provide help to the thrift industry and to housing, its continued applicability to the competitively significant accounts created since December 10, 1975, must be confirmed.

In our view, the most appropriate way to make congressional intent on this issue explicit would be to adopt legislation such as S. 2927, a bill recently introduced by Senator Morgan. S. 2927 would mandate a differential on any account category created after December 10, 1975. Initially, the interest edge given thrifts would be 25 basis points, but the differential required by the bill would decline by 5 basis points annually, beginning in June of 1981. Thus, the differential on post-1975 accounts would gradually diminish at a pace tied to the time frame for rate decontrol established by Public Law 96-221.

There is, to be certain, no way of predicting whether the rate of decline specified for the differential in S. 2927 would match precisely with economic conditions during the phaseout period. Nevertheless, it strikes us as a reasonable approach to the problem of insuring the persistence of a meaningful differential without compromising the task of reestablishing a free marketplace with respect to savings account interest. One very positive aspect of the bill, in our opinion, is that the guaranteed annual decline in the differential would provide a clear incentive to thrifts to move quickly to utilize the new powers authorized by Congress. At the same time, the bill's retention of an interest rate advantage for thrifts would minimize any disruptive impact that the transition to a market rate environment would have on the stability of those institutions and on their ability to supply the Nation's housing credit needs.

REDUCE FLEXIBILITY OF DIDC

One effect the bill would have would be to reduce the flexibility of the DIDC. We realize that an argument can be made that the committee needs the maximum possible flexibility to implement Congress' decontrol directive. The Bank Board, however, strongly believes that the need for assurance of the continuing presence of a meaningful differential is sufficiently great that a statutory directive on this issue is required. As you well know, the question of congressional intent regarding the differential, as it bears on past DIDC actions, is a matter of considerable debate, even among Members of the House and Senate, and is the subject of a lawsuit. For us to continue to have to rely on the legislative history of Public Law 96-221 obviously would represent a flawed approach to satisfying the will of the Congress as it pertains to the differential. In fact, it is one that could leave the direction of decontrol in the hands of the Federal judiciary. Again, we urge that the Congress take prompt action to make its intentions on this issue absolutely clear.

This concludes my statement. I will be happy to answer any questions you may have.

The **Chairman**. Thank you, Chairman Janis. Before we hear from Mr. Odom, we're going to call on Senator Cranston who I understand has a statement.

OPENING STATEMENT OF SENATOR CRANSTON

Senator **Cranston**. Thank you very much, Mr. Chairman.

This committee has worked long and hard on financial institutions legislation and I thought we had finally resolved the future of the thrift industry market rates for small savers and regulation Q by mandating an orderly plan for phaseout of regulation Q and phasein of market rates of interest over a reasonable period of time.

However, the Depository Institutions Deregulation Committee created to carry out this plan by recent preemptory action challenged the wisdom of Congress taken in Public Law 96–221 and in conflict with congressional aims the committee phased out much of regulation Q in 6 weeks, not in 6 years, and second, the committee dictated above market rates by establishing arbitrary non-market interest rates and, third, without concern for good consumer and public relations the committee, in what seems to me a highly autocratic manner, put forth an unduly complex interest rate structure imposed without regard for a needed breaking-in period for the public and for financial institutions.

In light of these actions, I wrote to Chairman Volcker on June 30 raising my concerns and I submitted 16 questions to the Committee. This letter was not answered until this morning so I have had no opportunity to review the responses. I hoped we would get some answers here today, Mr. Chairman. I must say that based on the recent activity of the committee and its lack of responsiveness, my confidence in this process and in the committee is certainly at a very low ebb.

I would like to insert my letter to Chairman Volcker into the record. It's dated June 30.

[The following letter and subsequent answer from Chairman Volcker follows:]

HARRISON A. WILLIAMS, JR., N.J.
ALAN CRANSTON, CALIF.
ADLAI E. STEVENSON, ILL.
ROBERT MORGAN, N.C.
DONALD W. RIEGLE, JR., MICH.
PAUL S. SARBANES, MD.
DONALD W. STEWART, ALA.
GEORGE J. MITCHELL, MAINE
JAKE GARN, UTAH
JOHN TOWER, TEX.
JOHN HEINZ, PA.
WILLIAM L. ARMSTRONG, COLO.
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M. DANNY WALL, MINORITY STAFF DIRECTOR
MARY FRANCES DE LA PAVA, CHIEF CLERK

United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, D.C. 20510

June 30, 1980

Honorable Paul Volcker
Chairman
Federal Reserve Board
20th & Constitution Avenue
Washington, D.C. 20551

Dear Chairman Volcker:

In March of this year Congress enacted the Depository Institutions Deregulation and Monetary Control Act. Section 203 of this Act created the Depository Institutions Deregulation Committee. The directive to this Committee contained under Section 204 states:

> The Deregulation Committee shall, by regulation, exercise the authorities transferred by section 203 to provide for the orderly phase-out and the ultimate elimination of the limitations on the maximum rates of interest and dividends which may be paid on deposits and accounts as rapidly as economic conditions warrant.

When Congress approved the Depository Institutions Deregulation and Monetary Control Act, it emphasized the gradual and orderly phase-out of present competitive disparities and directed the Committee to insure that this was carried out with the least injury to any financial institutions. Thus I wish to ask why the Committee at its May 28th meeting approved, in such a precipitous manner, an unusually complex scheme of interest rate regulations when its mandate was clearly deregulation. Indeed, it appears just as the money market certificate rates were dropping to the point where the differential would be helpful to thrift institutions, the DIDC quickly moved to protect the certificate balances which banks had managed to build up at the expense of thrifts simply because the differential on the MMC had been removed above 9 percent. It seems to me the DIDC could at least have waited six months until thrifts earnings had improved somewhat before it attempted to stabilize the flow of funds between competing financial institutions.

The focus of the debate last year was, indeed, on the importance of providing the thrift industry with sufficient lead time during which to make necessary adjustments to their new powers. I want to make clear that I do not seek to shield the thrifts, the banks or credit unions from a competitive environment which is inevitable and essential for their survival. And, I recognize that it is difficult to please everyone when making decisions. But I want to express concern about the impact of DIDC's initial determinations on its reputation in Congress and the financial community.

The DIDC is charged with a very delicate balancing act. It will seriously impair its effectiveness and its image with the public and with Congress if it does not discharge its Congressional directive in an orderly manner and if it fails to promulgate reasonably rational actions easily understandable to those under its charge.

I urge you to reconsider the actions you have taken, for they may well be having unintended consequences.

I will be scrutinizing the DIDC's future actions very closely. In view of these stated concerns, I am enclosing a list of questions regarding these recent actions. I would appreciate a prompt response.

Sincerely,

Alan Cranston

Alan Cranston

Enclosure

QUESTIONS FOR THE DIDC

1. With respect to the directives of P.L. 96-221 for gradual and orderly deregulation, how well prepared were the various depository institutions for the changes ordered to be implemented less than two weeks after their promulgation on May 28?
2. Could you explain the need for such an urgent action by the DIDC on these rates (in view of the fact that market rates were declining at the time)?
3. What projections, estimates, staff reports, or other data did the DIDC base its decisions for the May 28 action? (Please submit all available data for review to the Senate Financial Institutions Subcommittee.)
4. How far in advance of the May 28 meeting were these reports, data, et cetera distributed to the members of DIDC?
5. Was consideration given to the short term, as well as long term implications of the DIDC's actions of May 28 upon the availability of housing credit? If so, please explain what issues were discussed and the reasons for your actions on removing the differential. Please submit whatever reports or justifications led you to conclude that removal of the differential on the money market certificate was in the best interests of housing.
6. Would you give the Committee your definition of "market rate" that was used in setting the interest rates on the money market certificate and 30-month certificate.

7. Should the Congress establish a procedure for notice and opportunity to override the recommendations of the DIDC?
8. Why was it necessary for the Committee to take its May 28 action on rates "as soon as possible", and why did you consider the use of public notice and public comment period "contrary to the public interest"?
9. Explain how your new interest rate structure will help financial institutions compete with money market mutual funds?
10. Please explain how the Committee's actions will help savings institutions better serve the nation's housing needs? How will these interest rate changes generate new mortgage funds for housing?
11. Your explanatory statement indicates that part of your consideration in stabilizing certificate funds in banks was to assure that funds would be available for agricultural and small business loans, this reasoning appears to be dictated by monetary policy considerations and not by the legislative dictates of P.L. 96-221. Would you explain why this action was taken in the confines of DIDC as opposed to through Federal Reserve's credit policies.
12. Did the DIDC consider extending the differential to banks that had a large portfolio of mortgages, agricultural and business loans? If not, why not?

13. P.L. 96-221 charged you with the task of acting in the interest of the small saver and other consumers, would you explain how your action on interest rates and increased withdrawal penalities meet this criteria under P.L. 96-221.

14. Explain the reason for the Committee establishing minimum interest rate floors on the money market certificates and 30-month certificates above declining market rates?

15. How does this new complex infrastructure of interest rates reflect the Congressional mandate of P.L. 96-221 for the DIDC to move toward deregulation? What other more simple options were considered by the DIDC?

16. Your interest rate actions would seem to cause more funds to leave the regulated financial institutions for the money market funds because the average employee of a financial institution will not be able to explain these rates to customers and this kind of confusion will cause consumers to go to the more simple money market fund. From a marketing standpoint, financial institutions should be able to answer the question from a customer, "Can I get higher rates elsewhere?" What information are you providing to institutions to help them address these kinds of questions?

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

PAUL A. VOLCKER
CHAIRMAN

August 4, 1980

The Honorable Alan Cranston
United States Senate
Washington, D.C. 20510

Dear Senator Cranston:

I hasten to sign this letter transmitting to you replies to the questions you raised in a letter to me on June 30. I very much regret the delay in response, which I find can only be accounted for by mis-routing within the office of the Board of Governors of material sent to me in my capacity as Chairman of the DIDC. You may be assured that our procedures have been straightened out, but this assurance hardly can correct the lapse in this instance.

Sincerely yours,

Paul

P.S. I am more than chagrined — ordinarily I promptly see all Congressional correspondence, but not this one. I hope you can accept my apology.

Enclosure

1. With respect to the directives of P.L. 96-221 for gradual and orderly deregulation, how well prepared were the various depository institutio for the changes ordered to be implemented less than two weeks after their promulgation on May 28?

The DIDC actions taken on May 28 were not primarily designed as a part of the deregulation process, but rather to facilitate larger credit flows by depository institutions to specific credit markets--viz. for mortgage, agriculture, and small business credit. Adjustment in ceiling rates have traditionally been effective when announced; otherwise the public will refrain from acquiring deposits until the new ceilings become effective, thus disrupting deposit and credit flows. The Committee was aware of the administrative burdens faced by institutions in implementing the new ceilings rapidly, but felt that the need for the institutions to remain competitive in order to expand credit flows in specific credit markets outweighed these potential burdens. As you know, under both the new and old ceilings, the actual ceiling in any event needs to be changed at frequent intervals.

2. Could you explain the need for such an urgent action by the DIDC on these rates (in view of the fact that market rates were declining at the time)?

8. Why was it necessary for the Committee to take its May 28 action on rates "as soon as possible", and why did you consider the use of public notice and public comment period "contrary to the public interest"?

Floating ceiling deposits had been virtually the only source of growth of deposits subject to rate ceilings since mid-1978. The ceilings on such deposits are tied to the yields on Treasury securities of comparable maturities. Treasury security yields not only are generally below those on competitive investments, but also decline more rapidly than other rates as interest rates fall. Thus, the environment of declining rates made it propitious and desirable for the Committee to act to improve the competitive position of the depository institutions. Moreover, you will recall there was considerable uncertainty in the banking and thrift industries about the nature of any changes to be made, and prolongation of that uncertainty seemed undesirable.

3. What projections, estimates, staff reports, or other data did the DIDC base its decisions for the May 28 action? (Please submit all available data for review to the Senate Financial Institutions Subcommittee.)

The DIDC staff provided the Committee with judgmental estimates from simulations of deposit flows and earnings at depository institutions under various interest rate assumptions. In general these results showed that deposit and credit flows would be enhanced, while earnings would not be significantly affected by the DIDC's actions, assuming interest rates remained near their current levels. (In some scenarios, earnings seemed likely to increase). The earnings estimates of course reflected an assumption of profitable employment of enhanced deposit inflows. Copies of staff memoranda have been made available to you.

4. How far in advance of the May 28 meeting were these reports, data, et cetera distributed to the members of the DIDC?

The issues that prompted the May 28 actions were first discussed by the Committee at its May 6 meeting. DIDC staff was directed to prepare an analysis of a number of issues, including the possible re-emergence of the differential on the MMC and the competitive position of depository institutions relative to nondeposit market alternatives. The Committee met in closed session on May 20 and May 23 to discuss the interest rate outlook and review staff reports.

5. Was consideration given to the short term, as well as long term implications of the DIDC's actions of May 28 upon the availability of housing credit? If so, please explain what issues were discussed and the reasons for your actions on removing the differential. Please submit whatever reports or justifications led you to conclude that removal of the differential on the money market certificate was in the best interests of housing.

9. Explain how your new interest rate structure will help financial institutions compete with money market mutual funds?

10. Please explain how the Committee's actions will help savings institutions better serve the nation's housing needs? How will these interest rate changes generate new mortgage funds for housing?

The primary objective of the May 28 action, increasing the maximum allowable ceiling rates on MMCs and SSCs relative to Treasury yields, was to improve the competitive position of all depository institutions relative to their nondepository competitors, such as Treasury securities and money market mutual funds. Savings and loan associations, mutual savings banks, and smaller commercial banks--which are major lenders to housing, agriculture, and small business--were under liquidity pressure and were finding it increasingly difficult to compete with alternative market instruments. By allowing depository institutions the flexibility to offer higher returns, these changes should facilitate larger deposit inflows and a further extension of credit to the markets served by these institutions.

The DIDC left that 1/4 percent differential intact for 30-month savings certificates. Those longer-term deposits are considered more consistent with the longer-term nature of thrift institutions' portfolios, providing a more solid base and incentive for mortgage lending.

The DIDC, in establishing the new rate ceilings, also faced the prospect that the decline in interest rates would re-introduce a differential on MMCs. Small commercial banks, which are significant lenders not only in the mortgage market, but also to agriculture and small business, and which increasingly came to depend on MMCs as a source of funds in the year prior to the DIDC actions, could have faced substantial deposit attrition and subsequent pressure on their ability to extend credit if the differential re-emerged for a sustained period.

In light of this, while permitting the differential to reappear generally at levels of rates prevailing in recent months, the DIDC also permitted commercial banks temporarily to re-issue maturing MMC deposits to the same holder at a rate equal to the thrift ceiling. Moreover, the minimum deposit ceiling established made no allowance for a differential, mainly on the basis that should these minimums be effective, all institutions would be in a relatively favorable position.

Taking these competitive factors into account, the DIDC concluded that the May 28 actions, on balance, would induce a greater flow of funds into institution active in the residential mortgage market at rates consistent with profitable lending and lower mortgage rates than those then prevailing. To be sure, the decision on the differential could have been tilted further toward thrift institutions, but only by jeopardizing the flows of funds to smaller banks, hard pressed for liquidity, who were servicing the agricultural and small business (including car dealers and their customers), as well as home financing, markets.

6. Would you give the Committee your definition of "market rate" that was used in setting the interest rates on the money market certificate and 30-month certificate.

The floating ceilings on the 6- and 30-month deposits are linked to the rate on the 6-month Treasury bill and the 2-1/2 year Treasury constant maturity yield, respectively. These Treasury rates provide a practical basis for determining the ceiling on these two types of deposits. As indicated above, Treasury yields tend to be lower than other rates available to savers.

7. Should the Congress establish a procedure for notice and opportunity to override the recommendations of the DIDC?

I do not believe that such a formal notice and override procedure is necessary or desirable in the light of the elements of greater uncertainty that would be created.

11. Your explanatory statement indicates that part of your consideration in stabilizing certificate funds in banks was to assure that funds would be available for agricultural and small business loans, this reasoning appears to be dictated by monetary policy considerations and not by the legislative dictates of P.L. 96-221. Would you explain why this action was taken in the confines of DIDC as opposed to through Federal Reserve's credit policies.

Since small commercial banks--which are major lenders in agricultural and small business credit markets--had relied to such a great extent on MMCs to finance their loans, actions on MMC ceiling rates, which could only be accomplished by the DIDC, seemed required. Monetary policy actions to address this problem cannot generally differentiate among particular sectors of the credit markets, and a general increase in the money supply and total credit flows must take account of the general inflationary environment. I might add that the Federal Reserve did make special discount window credit available to these small institutions to assist in financing agricultural credit.

12. Did the DIDC consider extending the differential to banks that had a large portfolio of mortgages, agricultural and business loans? If not, why not?

No such proposal was formally presented to the Committee. Staff discussions, however, did consider the matter, and pointed to administrative difficulties of establishing and policing deposit rate differentials based on portfolio distributions. In some markets, for example, such a rule would mean that some large commercial banks, with access to the money market, might have no differential on small time deposits vis-a-vis small thrifts with no access to other sources of deposits. Such thrifts might then find themselves placed at a severe competitive disadvantage. We would, of course, also had highly anomalous competitive situations, with side-by-side banking offices offering different rates to their customers.

13. P.L. 96-221 charged you with the task of acting in the interest of the small saver and other consumers, would you explain how your action on interest rates and increased withdrawal penalties meet this criteria under P.L. 96-221.

Obviously, the increase in ceiling rates is to the benefit of small savers. However, there is considerable evidence that as interest rates rise, savers often withdraw their deposit funds prior to the contractual maturity, frequently redepositing the funds at the same institution. When interest rates are low lenders then become unwilling to readily commit new deposit inflows to long-term loans such as mortgages. A balancing of consumer benefits with the need to increase credit flows to mortgages, agriculture, and small businesses, thus suggested the desirability of having depositors share some of the interest rate risk that had been borne mainly by the depository institutions. The modification of the early withdrawal penalty rule only increased the depositors' cost of withdrawal in the first few months of the deposit's life and left the cost of withdrawal later virtually unaffected. Early withdrawal rules in the event of death or incapacity were not changed.

14. Explain the reason for the Committee establishing minimum interest rate floors on the money market certificates and 30-month certificates above declining market rates?

The minimum ceilings--not deposit rate floors--were set initially at levels near or below ceiling rates prevailing at the time the May 28 actions were taken. The anticipation of the Committee was that if Treasury security rates continued to fall, the minimum ceilings would insure the competitiveness of the depository institutions. As noted, Treasury yields tend to decline more rapidly than the yields or other instruments as interest rates fall. A minimum ceiling would thus better assure the ability of depository institutions to attract deposits at a time when their earnings pressures were easing. It would also permit the institutions to experiment with setting their own rates as a precursor to ultimate deregulation; indeed, if rates continued to decline--or remained at low levels--one would expect the institutions to begin to pay below ceiling rates.

15. How does this new complex infrastructure of interest rates reflect the Congressional mandate of P.L. 96-221 for the DIDC to move toward deregulation? What other more simple options were considered by the DIDC?

The major objective of the actions was not to move the ceiling rates toward deregulation. However, the actions do seem consistent with small progress toward the objective of deregulation in the light of the added flexibility provided institutions as indicated in answers to question 14 and other questions above. Other actions--such as raising fixed ceilings on all accounts--were considered as possibly bringing too much earnings pressure on institutions in the current environment with no more effective results in terms of flows.

16. **Your interest rate actions would seem to cause more funds to leave the regulated financial institutions for the money market funds because the average employee of a financial institution will not be able to explain these rates to customers and this kind of confusion will cause consumers to go to the more simple money market fund. From a marketing standpoint, financial institutions should be able to answer the question from a customer, "Can I get higher rates elsewhere?" What information are you providing to institutions to help them address these kinds of questions?**

With increased depositor awareness of alternative yields, the offering rate is the most important variable used in marketing financial assets to the public. The May 28 actions of the DIDC permit depository institutions to post a more competitive rate. The depositor (or the bank teller) need not be concerned with any added complexity in the rate formula because the institutions can continue to advertise in the same way as before by stating the nominal and effective interest rates for each type of deposit. When a depositor approaches a depository institution, the only difference apparent to him should be the increased yield he can receive now versus what he could have received under the old schedule.

The CHAIRMAN. Senator Garn.

OPENING STATEMENT OF SENATOR GARN

Senator GARN. Mr. Chairman, I have no lengthy statement to make today except to say that I'm certainly pleased that you called these hearings.

When we created the committee it was my understanding that it was to be in existence solely for the purpose of phasing out regulation Q, phasing out was to be done as soon as possible taking into account the safety and soundness of the various types of financial institutions. After 6 years DIDC was to go out of existence.

Mr. Chairman, as everybody knows, the recent actions of the DIDC has most of us scratching our heads trying to figure out what in fact it has done. Considering the fact that the members were supposed to deregulate, it seems to me they are going in the opposite direction. I have never received so many letters and calls from officers of financial institutions and savers expressing frustration and confusion over the actions of the DIDC. It seems as if they have created more regulation in areas where their activities were not really contemplated by the legislation which created them.

I am hopeful that these hearings will enable the DIDC to explain its actions clearly to us so that we can then make a determination as to whether or not further direction to them is needed. I look forward to hearing from the members of the panel and the witnesses we have here today.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Odom.

STATEMENT OF LEWIS G. ODOM, SENIOR DEPUTY COMPTROLLER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. ODOM. I am pleased to be here today to present the views of the Office of the Comptroller of the Currency on the actions taken to date by the Depository Insitutions Deregulation Committee and on S. 2927. we concur with the statement of Chairman Volcker concerning the activities of the DIDC. We believe that the deliberations of the DIDC have been constructive and the actions taken reasonable. Chairman Volcker has properly pointed out the several concerns that must be balanced by the Committee.

First and foremost, the DIDC is charged with the total elimination of interest rate controls over 6-year period as rapidly as economic conditions warrant. It should be recognized, however, as Congress did in its directive to the Committee, that other concerns and considerations weigh in the decisionmaking process. These include:

Providing small savers with competitive market rates of return as soon as possible.

Providing for an orderly phaseout of interest rates which gives due regard to the safety and soundness of depository institutions.

Promoting competitive equity among different types of deposit taking institutions as thrift institution powers are enhanced and deposit rate controls are relaxed and ultimately eliminated.

Assuring the ability of regulated deposit-taking institutions to compete with unregulated non-deposit-taking entities which are increasingly competing for funds traditionally placed with banks and thrift institutions.

Balancing a number of broader economic concerns including the soundness of the financial system in general; the maintenance of credit flows to significant sectors such as agriculture, small business and housing; the encouragement of savings; and the reduction of inflationary distortions in our economy.

BALANCING GOALS NOT EASY

The balancing of these goals and interests is not easy—either for the Congress or the DIDC. Inevitably, views will differ and, within the bounds set forth by the statute, compromises effected.

For example, at the OCC, we might favor raising ceilings somewhat more rapidly than others. We would do so because of our view that depository institutions can and will adjust relatively rapidly to an unregulated environment; because of our substantial concern for the competitive posture of deposit taking institutions in regard to their unregulated competition; and because of our support for the goal of providing small savers with a fair market return as soon as possible.

Notwithstanding such differences, we believe, as I have indicated, that the balance achieved by the DIDC is a fair and reasonable one. We also believe that the agencies and their staffs have to this point approached this difficult task in a fair and constructive manner.

In this regard, we believe that Congress acted wisely in granting broad discretion to the DIDC in shaping the mandated 6-year phaseout. This flexibility allows the DIDC to respond to economic and financial conditions. In addition, such flexibility allows the Committee to tailor future decisions based on evidence of the impact of actions already taken. As Chairman Volcker's statement indicates, we already have valuable information as to the impact onf the May 28 decisions, both of market flows and the condition of affected institutions.

For this reason, we do not favor adoption of the statutory schedule embodied in S. 2927 at this time. The DIDC, under existing law, has the authority to implement such a schedule if circumstances warrant. The certainty provided by a schedule such as that contained in S. 2927 or by one which is broader, setting a comprehensive phaseout timetable, has important benefits and should be considered. However, at this time, we believe prudence suggests that, for at least the balance of the year, we monitor the response of institutions and markets to deregulation prior to adopting any fixed schedule.

The CHAIRMAN. Thank you, Mr. Odom. Does any other member of the panel wish to make a statement?

[No response.]

The CHAIRMAN. Apparently not. Fine.

Chairman Volcker, first, with regard to the ban on finder's fees and premiums, was there unanimous agreement by the voting members that the proposed changes be put out for comment in the form they were finally approved?

Mr. VOLCKER. Yes. The proposal is only out for comments, but it was a unanimous decision to put that proposal out for comment.

The CHAIRMAN. Can you give us a brief review of the comments you have received to date on the proposed changes?

Mr. VOLCKER. There's been an enormous number of comments. My impression is that a good many comments have come from the industry involved in premiums, and they are opposed, as one would expect. There are comments from depository institutions on both sides, but my understanding is that they are predominantly in favor of the proposal, some with modifications, feeling that——

The CHAIRMAN. Both premiums and finders fees—they are in favor of both?

Mr. VOLCKER. Yes. I haven't analyzed these comments in detail; they are still being analyzed by staff so I'm giving you a very general impression. I think a good many institutions say they agree in general but there may be some role for premiums in opening up new offices, or new branches, or new forms of accounts.

The CHAIRMAN. Did you solicit the consumer groups?

Mr. VOLCKER. I don't know that we particularly did. It's obvious we solicited comments from everybody, but I don't have any impression of the consumer groups in particular.

NEED SAVINGS DESPERATELY

The CHAIRMAN. One of the reasons that this beautiful little fellow made in Madison, Wis., incidentally, should have an opportunity to continue to contribute to our economy is that, after all, this is an incentive to save and the limitations seem quite reasonable. At the present time, as I understand it, it has to be a premium that costs less than $5 if the deposit is up to $5,000 or $10 if it's more than that, and to have some loving mother or father wanting to establish a savings account for little Johnny or Janey with a nice doggie at the same time seems to me to be something that should be in the national interest. We need savings desperately.

Mr. VOLCKER. Particularly if it's made in Madison, Wis.

The CHAIRMAN. That's an important element.

Mr. VOLCKER. Our investigation so far suggests that most of the premiums are made in Taiwan or Japan or Korea, but the dog you speak of obviously is an exception.

Let me say that one of the problems—and I think it's apparent from just looking at the window displays of many financial institutions—is that the $5 and $10 limitation is being widely violated, and that was one of the main concerns members of the committee had. It's very hard to enforce the limitation, but it's apparent that the kinds of gifts being given are not consistent with the $5 and $10 limitation; that was one of the real difficulties in this area.

The CHAIRMAN. I would think any incentive to persuade people to save these days is something we should consider seriously.

Finders fees are quite different. At any rate, the proposed ban on premiums goes further than the current regulations of the Federal Home Loan Bank Board. Mr. Janis, can you tell us why you were in favor of the premium ban?

Mr. JANIS. I had two reasons, Mr. Chairman. First, things have just gotten out of hand in the country, in the Northeast in particular. My second reason involved the amount of time connected with trying to police the regulations. I remember that during the committee meetings Mr. Sprague had some very specific data from his New York district which he presented relative to the amount of examination time that was going into just policing the premium area, as well as, of course, into policing the finder's fees. I asked my people for similar data. They had no specifics, but I got impressionistic data from my Federal Home Loan Bank presidents in New York and Boston and from my examiner staff and they corroborated Mr. Sprague's findings that an inordinate amount of time was being spent on just trying to make sure that people didn't violate the $5 and $10 ban—which obviously was being violated, as Chairman Volcker points out, as one could see just by looking in any typical financial institution's window in certain parts of the country.

The CHAIRMAN. This is what happens when you try to suppress competition on a rate basis, on a logical basis. They will find other ways to compete and premiums are a way that seems to be not too evil and involves some incentive to save and involves some degree of competition.

Mr. JANIS. Well, it was an especially tough year for our examiners this year. We all felt, Mr. Chairman, that our examiners needed to be involved in more useful pursuits. There were some problems this year, as you know, in the savings and loan industry. A lot of those are behind us. But an inordinate amount of time was being spent on this type of activity.

The CHAIRMAN. How about trying to solve the problem by better reports on premiums from the institutions?

Mr. JANIS. Well, what was happening was that with regard to what appeared to us to be gross violations of the regulations, they would report to us that they were within the limits of $5 and $10. The fact of the matter, however, was that they were offering luggage and all kinds of other gifts that by any reasonable standard clearly would exceed the regulations.

The CHAIRMAN. You feel enforcing that regulation is so difficult that the only reasonable way to handle it seems to be to just prohibit outright any premiums at all?

Mr. JANIS. Yes. What was happening was that other institutions would call us and they would complain and say, "Now the fellow across the street is offering such and such and we're law-abiding people and we want to follow the regulations, but we can't follow them if the fellow across the street isn't following them." There was no way for us not to follow up on these kinds of complaints that we were getting.

The CHAIRMAN. Wouldn't it have been easier to close the loopholes in the regulation? For instance, it didn't include packaging or transportation costs and that kind of thing.

Mr. JANIS. Well, the regulations were already overly complicated in my judgment. I think that the simplest way and the fairest way, because of the gross violations, simply was to say that the premiums were not serving a useful purpose considering the amount of time required to keep up with what was happening. This was a time of great competition for savings and people felt that various ways of trying to get a competitive edge were necessary for survival.

OBJECTION TO FINDER'S FEES

The **Chairman**. It's a little easier for me to understand the objection to finder's fees. As you say, they can be phonied up pretty easily. Did you consider simple prohibition of finder's fees and apply it to savings and loans and mutual savings banks?

Mr. **Janis**. Well, I don't recall——

Mr. **Volcker**. If I may interject here, Mr. Chairman, the committee has not taken final action on this and——

The **Chairman**. I realize that.

Mr. **Volcker**. Nobody's thinking is cast in cement on these issues. I would agree that the finders fees may be a more important problem than premiums, although there is a problem with premiums. The thrust of many comments was that the ceilings in effect shouldn't be raised. What do you do about a premium when it is in effect an indirect way of raising the rate ceiling? So there is a problem with premiums. But I just don't want you to assume that the committee has made a final decision. Obviously, its tendency at that time was to go in the direction of banning premiums, but there are many way stations between complete banning and the present situation.

The **Chairman**. Could I ask you, Mr. Connell, does the Credit Union Administration current regulation ban the use of either premiums or finders fees?

Mr. **Connell**. No, it doesn't, Mr. Chairman. We paralleled the other agencies in our regulation of that aspect. We did propose a regulation to ban premiums and finders fees much as the committee did following the action of the committee.

I should note in the public record of the open meeting of the Depository Institutions Deregulation Committee my vote in favor of the proposed regulation was really to get it out for comment. It didn't reflect my views on the substance of the issues.

The **Chairman**. Mr. Sprague, could I ask you, what's the philosophical basis for banning the use of a common marketing tool used by many other businesses—grocery stores, retail stores, gas stations. Why should banks be prohibited from offering a premium?

STATEMENT OF IRVINE SPRAGUE, CHAIRMAN, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. **Sprague**. Well, it's been suggested the premiums and the finders fees are two separate issues, if I could address them separately. The finders fees question goes straight to violation of regulation Q. Congress has established regulation Q and if part of the finders fee goes to the depositor, that's a violation. It's extremely difficult. We noted an extraordinary display of human generosity and lack of greed in one institution, that during the 6-month period ending June 30, had 17,032 people who deposited $10,000 in the institution and with no additional gain to themselves apparently provided 17,032 television sets to others. It is extraordinary generosity of this nature that suggests to me that regulation Q is being honored in the breach in that respect.

PREMIUMS GOTTEN OUT OF HAND

With respect to the premiums, from our viewpoint, it was simply a situation that had gotten out of hand. Our examiners felt they could be spending their time on other matters. Our experience we paralleled Jay's problems last spring. We had some very significant situations we were working on. An extraordinary amount of time was spent by our people, particularly in the northeastern regions, answering complaints that came usually from competing institutions. The New York superintendent sent me a letter yesterday in which she said that because the Deregulation Committee has agreed not to take any action effective before the end of the year, she's been forced to send letters to all institutions warning them against misleading the consumer in the premium area. She lays out a number of ways in which consumers are being misled and warns the institutions against such activities during this period when we are deliberating this matter at the Federal level.

The **CHAIRMAN**. Senator Garn.

Senator **GARN**. Thank you, Mr. Chairman.

Chairman Volcker, on June 26 of this year, I wrote you a letter expressing my concern about the committee's action in dipping into or invading a person's principal if sufficient interest has not accrued to pay the penalty for early withdrawal of time deposit funds. An action resulting in the reduction of principal is not an interest penalty as I understand it. I understand it was designed to discourage early withdrawals and subsequent reinvestment in higher yielding deposits, but there certainly are very legitimate reasons for withdrawal—medical emergencies and so on—and I'm certainly not here to attack the fact that there should be interest penalties imposed on people who withdraw early. I understand what is being done there. But to deposit one's funds in financial institutions and not have the security that your principal will remain in tact, I really don't understand the penalty of dipping into one's principal, particularly in the light of the fact that a lot of depositors could have severe emergencies and need to withdraw their funds.

Also I understand there was no opportunity for public comments on this particular proposal. I would like you to explain the actions of dipping back into somebody's principal, why you think that is not too harsh an action, and why there was no comment period allowed.

DIPPING BACK INTO PRINCIPAL

Mr. **VOLCKER**. The nature of the problem, perhaps, will explain why the decision was made to invoke a penalty that would involve some loss of principal if a deposit were withdrawn prior to maturity after a few weeks or a few months. You have a situation in which time deposits with a certain fixed maturity are being issued by an institution. The institution, in effect, takes the risk: if market rates go down, it is stuck with the obligation for whatever the maturity of the deposit may be. We found that when interest rates were going up—and it doesn't take much of a rise in the very early weeks—which is the problem—a depositor in some sense lost. If interest rates went up shortly after he had obtained a 6-month or 2½-year certificate, he just came into the institution and said, "I'll take my money out and I'll go to another institution, or I'll go to the money market fund." Or, he'd even take advantage of the rising rate level at the same institution. If you confine the penalty to purely accrued interest, the penalty, by necessity, is going to be very small during the very early weeks. This is where the problem arose, with people in effect withdrawing after the first week or 2 weeks, whenever there was a fairly small change in interest rate level.

Take in contrast the fellow buying a Treasury bill or Treasury security: If the interest rate goes up after he buys the security, the same thing happens to him. In fact, it's likely to happen to him more decidedly. The security goes down in market value, and if he wants to sell at that point—if he wants to get out—he takes the risk of the loss in principal.

In a sense, it doesn't seem unreasonable to have a depositor, in effect, share the risk that formerly was entirely on the institution.

The practical effect, given recent experience, was to make institutions more hesitant about putting that money into the mortgage market or into other lending activities, because while the deposit normally had a nominal term of 6 months or 2½ years, in many instances the nominal term did not turn out to be the real term.

The regulation does provide that in certain cases such as death or other extreme emergencies those penalties don't apply. Those emergencies are fairly closely defined as I understand the regulation; I forget just where the margin is, but there are certain instances of an emergency character where the penalty would not apply. But it's also true that you just can't come in and plead illness.

Let me say that this invasion of principal, so to speak, lasts for a limited period of time; it occurs only in the early weeks or months of a deposit. You don't have to wait until the whole deposit matures.

Senator **Garn**. It's the first 3 months on 1 year and beyond 1 year it's 6 months.

Mr. **Volcker**. I don't remember just where the break point is.

Senator **Garn**. Well, it's 3 months and 6 months.

Mr. **Volcker**. It's 3 months and 6 months?

Senator **Garn**. It's 3 months on 1 year or less, and over 1 year it's 6 months.

Mr. **Volcker**. OK.

Senator **Garn**. It's a considerable amount of time that has to elapse or else the penalty will become effective. I just feel it's overly harsh.

Mr. **Volcker**. It's obviously a matter of judgment as to just how harsh this penalty should be. The common reason for wanting to withdraw an account just entered into for a considerable period of time is that interest rates have risen in the space of a couple weeks or a couple of months.

The invasion of principal does not bother me as a matter of principle. Just how harsh it should be is a matter of judgment.

Senator **Garn**. What about the occasion when interest rates are dropping and someone has an emergency and has to withdraw funds. The harsh penalty would have to apply at that time as well.

They obviously at this time would not be cashing in their CD to reinvest it at a higher rate.

Mr. **VOLCKER**. At that time they wouldn't be doing it for that purpose.

Senator **GARN**. But you're going to dip into their principal if they do, even if interest rates are not going up.

Mr. **VOLCKER**. I think that case is relatively rare. As I say, we made some allowance for those kinds of situations, but there would obviously be a policing problem if we made it so vague and open that, in effect, there was no way of specifying the type of emergency.

Senator **GARN**. What about the second part of my question as far as why there is no provision for public comment on this particular proposal?

Mr. **VOLCKER**. I don't remember precisely the discussion on that point. As I recall, this was put out as part of the package of changes that were made at that time. I think it seemed reasonable to get them all out on the table and in effect. I suppose there was some feeling that in view of the problems of the economy and the depository institutions and the desire to encourage a flow of funds through these institutions and have the money placed in credit markets, we wanted to get the benefits of these changes as soon as possible.

NO PERIOD FOR PUBLIC COMMENT

Senator **GARN**. I understand that it was a Wednesday or Thursday that you put out the proposal and it became effective on a Monday or Tuesday, just a very, very short period of time. I'm hardly known as a defender of the consumer, at least by some of the consumer rating groups, but it appears in this that the attitude by the DIDC is that the public be damned, and the DIDC decided, that it was going to be implemented in a matter of a few days. I don't see that the emergency was so great that you can't at least have a period for public comment.

And this is the thing that disturbs me most, whether I happen to agree or disagree with the individual action or what the public's reaction to it is, is that the public doesn't have an opportunity to at least respond and have input into your decisionmaking process before you make it final—a very brief period of time of 4 or 5 days at the most.

Mr. **VOLCKER**. It was a very brief period of time. I don't recall any considerations beyond the ones that I have indicated. Of course, the new penalty only applies to deposits made after the effective date; it didn't affect any existing deposits.

Senator **GARN**. I understand that, but I really can't justify not having a public comment period on that. That is, I suppose, one of the things, whether it's the Fed or this committee or the Federal Home Loan Bank Board or any Government agency, that causes more wrath from the public and more irritation and more of the stories about bureaucrats and bureaucracy and more difficulties. It just seems that we would have a little more commonsense to be able to listen.

I'll guarantee you, I used to sit through all kinds of planning and zoning hearings when I was mayor and we may have decided what we thought was best, but we always at least listened and had comment from those who were going to be affected by our decisions. Whatever your decisions are and whether you agree with the public comment or not, it would seem to me you ought to have, even if you ignore it, to at least go through the motions of having listened.

Mr. **Volcker**. I think generally that is a valid approach.

Senator **Garn**. Mr. Janis makes a very strong point that the thrifts must be able to use their powers before they can effectively compete with banks. Merely having this power in law is not sufficient. In light of this, I don't understand the May 28 committee actions which removed the differential 7 months before the thrifts could start to use their new powers.

My question, Jay, is what was your position in discussing these issues before the committee and how did they respond to your arguments?

COMPROMISE LEGISLATION

Mr. **Janis**. Senator, I was not pleased at all about the removal of the differential in terms of the way it was done by the committee. I argued strongly that I felt that such action would be counter to the will of Congress. I felt that what Congress had done was construct a very careful piece of compromise legislation——

Senator **Garn**. May I just interrupt you at that point to say amen? After months and months of working with this and the brief extension and then right in this room the late night session, I suppose that's the thing that bothers us more about the actions of this committe than anything else. Any of your staff who were here and listened to the conversation and the compromises that were made that night the conference committee met should know what what on. I don't think anybody could conclude as a member of this committee that what DIDC has done fit in with the spirit of that last evening of putting that bill together, that your actions were rather precipitous and after we had gone through the proposal for automatic ratcheting and done away with that and structured the committee, so please continue——

Mr. **Volcker**. May I say that my interpretation of that is quite different at this point. I don't want to interrupt Chairman Janis, but——

Senator **Garn**. I don't know who was here listening for you. Obviously conference committees are not recorded. There isn't a record that we have. It was open, but I certainly was here and the chairman was certainly here.

Mr. **Volcker**. Perhaps I can return to the point.

Mr. **Janis**. What I thought Congress had done, and done very well, was to construct a piece of legislation that would allow for the gradual phasing in of certain new asset powers. I think Congress understood that those new powers would not be in use immediately. There was no way they were going to be in use in 1 month or 3 months or even a year. Three to 5 years and perhaps 6 years in all would be needed for the phasing in of these powers. The idea was that the balance sheets of these thrift institutions could be reconstructed using these new powers as they came on stream. I think what Congress wanted, if I understand the process properly, was to dovetail the phasing in of the new powers with the gradual elimination of decontrol of rates and the differential. I even argued, Senator, for the restoration of the differential above 9 percent on money market certificates. Originally, the money market certificate had the benefit of the differential, but, as economic conditions changed, I understand it was felt by the ICC, the DIDC's predecessor that housing starts were too strong and a decision was made to eliminate the differential above 9 percent. In terms of DIDC's actions, I felt that housing had fallen to a point where it would make sense to restore the differential above 9 percent.

I consulted, in fact, with Mr. McKinney, who was my predecessor, and that is his recollection. In fact, he indicated to me and he authorized me to say that it was his understanding of the ICC that if housing starts were to slump, the differential would be restored, a position that I took at the DIDC, which was not what the rest of the committee felt was appropriate.

Senator **Garn**. Thank you. My time is up.

The **Chairman**. Without objection, so ordered. Senator Morgan.

PHASING OUT THE HOUSING DIFFERENTIAL

Senator **Morgan**. Mr. Chairman, in the interest of time, I won't raise any questions about gifts because I think the chairman has already adequately explored that area, except to say that I am concerned about the proposed regulation. How far are you going to go in regulating the financial institutions? Are you going to say to them that they cannot employ any kind of marketing technique to increase their share of the market? I can understand your concern about finders fees because I have seen some of the advertisements of Cadillacs and so forth, and I know that there is a dividing line and should be a dividing line between a legitimate gift designed to attract customers and a finders fee or gift that's simply a way to circumvent interest limitation, but I think we've got to leave a little area for the various institutions to use some imagination and ingenuity in competing with each other. The penalty area has already been explored, but what has concerned me more than anything else has been the action of the committee with regard to phasing out what I call the housing differential.

Mr. Volcker, did you read the legislative debates from the Congressional Record that went on during the passage of this bill?

Mr. **Volcker**. I've read some of them.

Senator **Morgan**. It seemed to me if you had read them, it would have been clear that the Senate at least was concerned about the viability of depository institutions in carrying out this phaseout of regulation Q. For instance, with regard to the conference committee that Senator Garn was asking you about, it had this to say:

> The conferees agree that the phaseout must be accomplished in a way that ensures equity for depositors, especially those savers with small accounts and ensures competitive equity among depository institutions, and between depository and non-depository institutions that compete for the same depositor. The conferees also agreed that the phase-out must be handled with due regard for the financial viability of depository institutions.

Now will you explain to me first of all—you understand, of course, that many of your thrift institutions are still carrying home mortgages as low as 6 percent and some even below that?

Mr. **Volcker**. Right.

Senator **Morgan**. You understand, of course, that these mortgages are not variable rate mortgages. They are fixed mortgages and they are caught with them. Now you also understand, do you, that the thrift institutions have been limited or certainly the savings and loans to basically real estate or home mortgages through all these years and that these new powers that we gave them—consumer finance and trust powers—first of all, were sort of minimal to begin with and they had not been instituted at the time this thing was enacted.

Now it seems to me what you have done—and I'm sure you have done it in good faith, but I must say that I'm shocked by some of the mail I've gotten from the American Bankers Association members, I think we have a good system of financial institutions in this country and the American bankers have done very well and I'm for them, but could you explain to me how you expect thrift institutions to remain viable under this? The industry has shown a loss for the first time in history.

Mr. **Volcker**. I would be glad to, because I think the summary you gave of the congressional intent is precisely as I understand it and as I think other members of the committee understand it. I think we have not only acted in good faith to carry out the intent but we have acted effectively. I think the actions we took were frankly good for housing, good for thrifts, and good for the viability of thrifts over time, and I think they are good for competition and good for savings. And they are a step toward deregulation.

Senator **Morgan**. First of all——

Mr. **Volcker**. Let me explain.

Senator **Morgan**. All right. Just don't make a speech. Just try to answer my question.

Mr. **Volcker**. I'll explain it against the background of those objections.

Senator **Morgan**. We want to see this through if we have to stay here all day.

DIFFERENTIAL ACTIONS

Mr. **Volcker**. Others have mentioned getting rid of the differential. We didn't get rid of the differential. We left the differential intact on those deposits which we thought were most promising in terms of supporting the housing market and were likely to be supportive of thrifts in their mortgage activities. I'm referring to the 2½ year and longer certificates; the differential was not changed on those.

We had a situation where there was no differential above 9 percent on the money market certificates; the differential began under 9 percent. That situation was modified, the differential was not removed; it continues to phase in below 9 percent at a level that we consider sufficiently low—it's a matter of judgment—that all the institutions should be able to compete reasonably well. We adopted the minimum ceiling which does not include a differential, but the differential was not removed. In fact, the differential has been in effect for the great majority of time since the decision was made on the 6-month certificate. It's in effect fully on the 2½ year certificate.

The reason we increased the rate on both of those certificates relative to Treasury securities was to meet what we think is the major challenge for all these institutions; that is, competing better with market instruments and competing better with money market funds. Money market funds, while they are relatively new and in a relatively small set of institutions, have been attracting more funds in most months than all these institutions put together. That's where the major challenge has come. Those money market funds are not putting money into housing; they are not putting money into small business; they are not putting money into agriculture. We wanted to encourage the flow of funds out of the market, out of Treasury securities, into depository institutions that were putting money into agriculture and housing.

The decision we adopted was to put those institutions in a somewhat better competitive position. Events since then have shown that the thrifts have had a greater growth of these small time deposits than commercial banks.

Senator MORGAN. Tell me about it. Give me some figures.

Mr. VOLCKER. They are attached to my statement on page 14, attachment 3. As you can see—the table is a little complicated—both sets of institutions, commercial banks and thrifts, have lost 6-month money market certificates. I would point out that they both lost 6-month money market certificates despite the fact that we increased the rate they could pay relative to Treasury securities. The only conclusion I can draw is that they would have lost still more had we not made that adjustment. But they both lost MMC funds. They both gained funds through 30-month certificates, and they gained more on the 30-month certificates—particularly the savings and loans—than they lost on 6-month certificates. In our judgment the 30-month certificate is a more reliable base for mortgage lending—I think the institutions would have to look at it that way too—than 6-month certificates, given the potential volatility of the 6-month certificate. The surprising thing I guess to many of us out of this process is that both types of institutions have gained savings deposits, good old traditional savings deposits, at low interest rates during this period.

Senator MORGAN. Your commercial banks have gained 38 percent and the thrifts have only gained 20 percent.

Mr. VOLCKER. That's right; that is in savings deposits which were not touched by any of these actions. The only thing we affected was the small denomination time deposits.

Senator MORGAN. How much of those were affected?

Mr. VOLCKER. All the small-denomination time deposits were affected in terms of new inflows. We made small-denomination time deposits more attractive to the saver then they otherwise would have been.

Senator MORGAN. Well, I differ with you on a number of things, but in the interest of time, tell me what is the percentage——

EARNINGS IMPROVED

Mr. VOLCKER. If I may make one other point, the staff analysis at the time these decisions were made suggested strongly that the earnings of the thrift institutions would not be adversely affected by these actions and, indeed, were likely to be improved as a result of the actions of the committee. Now that sounds a little strange when we——

Senator MORGAN. It sure does.

Mr. VOLCKER. I will explain why that happens. To the extent institutions get a bigger inflow than would otherwise take place and are able to invest that at current market rates and make a profit, then the bigger the inflow, the bigger their profit on the new funds, which offsets the effect of the higher rate that they pay. I don't know how that will work out in practice. All I can say is that the staff analysis that we had suggested that both of these institutions were rapidly moving beyond the low point in their earnings picture—when they were under very great pressure, as you point out—and the action taken by our committee more likely than not would help their earnings picture rather than hurt it.

Senator MORGAN. Well, I differ with you on that, but my time has run out and I was afraid it would, but for the sake of the record, will you furnish me the percentage of commercial banks resources that are invested in housing and that of the thrift institutions that are invested in housing?

Mr. VOLCKER. Yes, I would be glad to and I would like to make a breakdown there of small and large banks; I will provide you with both.

[Chairman Volcker subsequently submitted the following information for the record:]

Commercial banks held $253 billion in total mortgage assets and $163 billion in residential mortgages at mid-1980, accounting for 18 and 16 percent, respectively, of the aggregate amounts outstanding. In addition, banks held more than $5 billion of federally guaranteed mortgage passthrough securities representing shares in pools of FHA/VA and conventional residential mortgages.

During the 1977-79 period, banks added more than $90 billion to their total mortgage assets and nearly $65 billion to their residential mortgages, and accounted for about one-fifth of the total net flows of these types of credit (tables 1 and 2). The commercial bank share of net mortgage lending typically declines in periods of cyclically high interest rates, as do the shares provided by other types of depository institutions. During the first half of this year, however, the commercial bank portion of mortgage lending held up much better than the market shares of the nonbank thrift institutions.

Among commercial banks, smaller institutions tend to allocate a greater portion of their resources to the mortgage market. At commercial banks with assets of under $500 million, mortgage loans constituted almost 25 percent of outstanding loans and investments as of December 31, 1979; this compares with 17 percent at large commercial banks (table 3). Additionally, almost 27 percent of the smaller commercial banks had ratios of mortgages to loans and investments that were 30 percent or higher, while the comparable figure for large banks was about 14 percent (table 4).

TABLE 1.—NET FLOWS OF MORTGAGE CREDIT BY TYPE OF INSTITUTION

[In billions of dollars]

Period	All institutions	Thrift institutions			Commercial banks	All other private institutions	Federal and related agencies	Federally related mortgage pools
		Total	S&L's	MSB's				
Total mortgage credit:								
1970	32.8	12.0	10.2	1.8	2.5	11.0	5.7	1.6
1971	52.3	27.9	24.0	3.9	9.2	7.2	3.2	4.8
1972	77.0	37.5	32.0	5.5	16.8	14.5	3.3	4.9
1973	79.9	32.2	26.5	5.7	19.8	17.7	6.6	3.6
1974	60.5	19.8	17.6	2.2	12.8	10.5	11.6	5.8
1975	57.2	31.8	29.5	2.3	3.8	2.7	8.6	10.3
1976	87.0	49.0	44.9	4.1	14.3	8.1	−0.1	15.7
1977	134.0	64.7	58.2	6.5	27.4	18.1	3.3	20.5
1978	149.2	58.7	52.2	6.5	35.0	25.4	11.8	18.3

TABLE 1.—NET FLOWS OF MORTGAGE CREDIT BY TYPE OF INSTITUTION—Continued

[In billions of dollars]

Period	All institutions	Thrift institutions			Commercial banks	All other private institutions	Federal and related agencies	Federally related mortgage pools
		Total	S&L's	MSB's				
1979	158.0	47.0	43.2	3.8	31.5	36.0	15.4	28.1
1980–H1	109.0	13.0	12.0	1.0	16.5	37.8	22.4	19.3
Residential mortgage credit:								
1970	22.9	10.5	9.2	1.3	1.0	4.9	5.3	1.2
1971	40.6	23.9	20.9	3.0	6.4	3.4	2.7	4.2
1972	56.6	32.4	28.3	4.1	10.8	6.6	2.5	4.3
1973	55.3	27.3	23.3	4.0	12.1	7.9	4.8	3.2
1974	40.2	16.3	14.9	1.4	7.2	2.3	9.2	5.2
1975	41.4	26.6	24.9	1.7	.4	−1.3	5.8	9.9
1976	67.3	43.4	40.2	3.2	8.9	2.7	−2.4	14.7
1977	107.3	59.7	54.0	5.7	19.8	7.8	.3	19.7
1978	115.4	54.9	49.5	5.4	23.5	11.2	8.7	17.1
1979	116.3	43.1	40.0	3.1	20.3	17.6	9.9	25.4
1980–H1	75.0	12.3	11.5	0.8	10.5	19.3	15.3	17.6

Note.—Data for 1980–H1 are partially estimated and expressed at seasonally adjusted annual rates.

TABLE 2.—SHARES OF NET FLOWS OF MORTGAGE CREDIT BY TYPE OF INSTITUTION

[In percent]

Period	All institutions	Thrift institutions			Commercial banks	All other private institutions	Federal and related agencies	Federally related mortgage pools
		Total	S&L's	MSB's				
Total mortgage credit:								
1970	100	36.6	31.1	5.5	7.6	33.5	17.4	4.9
1971	100	53.3	45.9	7.4	17.6	13.8	6.1	9.2
1972	100	48.7	41.6	7.1	21.8	18.8	4.3	6.4
1973	100	40.3	33.2	7.1	24.8	22.1	8.3	4.5
1974	100	32.7	29.1	3.6	21.2	17.4	19.1	9.6
1975	100	55.6	51.6	4.0	6.7	4.7	15.0	18.0
1976	100	56.3	51.6	4.7	16.4	9.3	−.1	18.1
1977	100	48.3	43.4	4.9	20.4	13.5	2.5	15.3
1978	100	39.3	35.0	4.3	23.5	17.0	7.9	12.3
1979	100	29.7	27.3	2.4	20.0	22.8	9.7	17.8
1980–H1	100	11.9	11.0	.9	15.1	34.7	20.6	17.7
Residential mortgage credit:								
1970	100	45.9	40.2	5.7	4.4	21.4	23.1	5.2
1971	100	58.9	51.5	7.4	15.8	8.4	6.6	10.3
1972	100	57.2	50.0	7.2	19.1	11.7	4.4	7.6
1973	100	49.3	42.1	7.2	21.9	14.3	8.7	5.8
1974	100	40.6	37.1	3.5	17.9	5.7	22.9	12.9
1975	100	64.2	60.1	4.1	1.0	−3.1	14.0	23.9
1976	100	64.5	59.7	4.8	13.2	4.0	−3.5	21.8
1977	100	55.6	50.3	5.3	18.5	7.3	.3	18.3
1978	100	47.6	42.9	4.7	20.4	9.7	7.5	14.8
1979	100	37.1	34.4	2.7	17.5	15.1	8.5	21.8
1980–H1	100	16.4	15.3	1.1	14.0	25.7	20.4	23.5

Note.—Data for 1980–H1 are partially estimated and expressed at seasonally adjusted annual rates.

TABLE 3.—MORTGAGE ASSETS AT DEPOSITORY INSTITUTIONS, DECEMBER 1979

[Dollar amounts in billions]

	Total mortgages		Residential		Other[1]	
	Outstanding	Percent of loans and investments	Outstanding	Percent of loans and investments	Outstanding	Percent of loans and investments
Commercial banks, assets of (millions of dollars):						
Under 50	45.5	23	27.7	14	17.8	9
50 to 99	27.6	25	16.1	14	11.5	11
100 to 499	50.4	23	28.4	13	21.9	10
500 and over	121.8	17	71.7	10	50.1	7
All banks	245.2	20	143.9	12	107.3	8
Savings and loan associations	475.8	83	394.4	69	81.4	14
Mutual savings banks	98.9	62	64.7	41	34.2	21

[1] For commercial banks, includes all construction loans secured by real estate, amounting to about $30,000,000,000. According to HUD, nearly half of the construction loans held by all commercial banks are secured by residential real estate, but information on the property-type distribution of construction loans is not available for the bank size groups shown in the table.

TABLE 4.—DISTRIBUTION OF COMMERCIAL BANKS BY ASSET SIZE AND RATIO OF MORTGAGE LOANS TO TOTAL LOANS AND INVESTMENTS

[In percent]

Asset size (in millions)	Percent of commercial banks with ratios of mortgage loans to total loans and investments of				
	1 to 9	10 to 19	20 to 29	30 to 39	40 or more
Less than $50	23.1	28.8	24.9	15.8	7.5
$50 to $99	7.4	26.5	35.5	22.7	7.9
$100 to $499	9.2	25.9	35.9	22.5	6.5
$500 or more	18.9	36.9	29.9	12.5	1.7
All banks	19.9	28.4	27.2	17.2	7.3

Senator MORGAN. I'll come back to that.

The CHAIRMAN. Senator Kassebaum.

Senator KASSEBAUM. I just have one question, Mr. Chairman. When the DIDC did draw up the differential regulations, there's no differential at the lower and higher end of Treasury bill rates?

Mr. VOLCKER. For the 6-month certificates. That is not true for the 2½-year certificate.

Senator KASSEBAUM. Of course, this is one of the major objections of some institutions, as you well know. The other one, of course, is that the DIDC acted too quickly and without predictability for what future actions might be. This is one thing that Senator Morgan's bill seems to address.

But my question is really this factor on the differential and is there some strong market reason that you feel there should be no differential existing at the lower or higher level?

Mr. VOLCKER. I would approach it from another direction in the context of this committee. We are charged over time, with deregulating and eliminating these ceilings. At that point, by definition, there's no differential. In that context, you're working toward a situation in which there will be no differential, although that doesn't mean that there need be any haste in that approach.

The other side of the differential question, of course—and while the general nature of the committee action seems to me constructive all around—is a matter of fine judgment as to just when you make these changes. While housing has been a major concern of Congress and a major concern of the DIDC we were dealing in an environment in which smaller commercial banks, particularly in the Midwest, had been under very considerable pressure with respect to agricultural lending, as you well realize. There's been a great deal of commentary about the pressures on small businesses and on automobile dealers in particular, and I suppose if I analyzed my own letters from Congressmen reflecting concern about various aspects of the credit market, they would show a close race between those concerned about housing and those concerned about agriculture and small business. While it is true that banks do not have the percentage of their assets in mortgages that thrift institutions do, small banks do have a very sizable percentage of their assets in mortgages and the rest mostly in agricultural loans and small business loans; and their loan-deposit ratios tend to be very high.

The reason we explicitly—again it's a matter of judgment—decided to permit, at least for a while, a rollover of the 6-month certificate without a differential was frankly concern over a sudden drain of funds at small banks that would create much uncertainty in their lending activity.

Senator **Kassebaum**. I understand that, but I'm wondering if you felt there were certain market judgments brought to bear for the lower and higher differential elimination there in regard to the Treasury bills.

Mr. **Volcker**. There certainly was a market judgment on the minimum ceilings, which was that if there were a minimum ceiling—at a rather low interest rate relative to what we have had—all depository institutions could compete freely in a relatively favorable environment. I think the feeling probably was that the differential would be much less significant when these institutions were all in a relatively favorable competitive position should market rates continue to decline. They could make their own judgments. In that sense, it was a small step—I would not argue any more than a small step—toward the ultimate objective which is deregulation.

Senator **Kassebaum**. I think the concern that certainly is reflected in some of the institutions is a lack of predictability given the uncertainty of the economic picture anyway, which is one of the things that Senator Morgan is trying to address, and I can understand how you arrived at your decision. On the other hand, I can also understand those who might wonder 3 months from now——

Mr. **Volcker**. I fully agree with that, and I think that is a strong argument for Senator Morgan's approach. That has to be balanced but against the unforeseeability of the future. You may find that maybe you want a higher differential than Senator Morgan's bill provided at some time in the future, or a lower one. Those two onsiderations have to be balanced out, but I certainly agree this predictability aspect is the major plus in his approach.

Senator **Kassebaum**. I would also like to say I certainly agree with you, Chairman Volcker, that we need better competition with he money market funds and this is one of the underlying factors I hink in the whole changing picture that we're trying to address. hat's all I have.

The **Chairman**. Senator Mitchell.

Senator MITCHELL. Just following up on what you just touched on, as I understand Senator Morgan's legislation, it seeks to introduce certain phasing out of the interest rate differential and, as I read your statement—I wasn't here to hear all of them, but as I looked at them, all of you except Mr. Janis opposed the legislation on the grounds you need flexibility to meet changing economic conditions.

As Senator Kassebaum has just pointed out, flexibility to you means uncertainty to others, particularly in light of the suddenness and lack of public participation in your May decision, and I guess there's no greater human fear than fear of the unknown. That's essentially, as the chairman pointed out, a balance.

My question is, and I would ask Chairman Volcker and Mr. Janis to address this specifically and anybody else who wants to—would not this legislation be advantageous in eliminating that uncertainty even at the price of some reduction in your flexibility? Whichever way you go, there's an advantage and disadvantage to either point of view, and I would like to ask you to assess the relative benefits and disadvantages of flexibility and uncertainty on the one hand and rigidity but elimination of uncertainty on the other.

Mr. VOLCKER. I can only say my own instinct—and I suppose it's nothing more than an instinct—is that the chances are that during this period there will be times when we will wish we had the flexibility more urgently than we will wish we had the certainty. I think it is a matter of balance, but that's why I came out the way I did. I recognize there are competing considerations and I can well understand the desire to get a fixed schedule in this particular area that's been so controversial.

Senator MITCHELL. I have a feeling S. & L.'s don't really think there might be an increase in the differential during this period, though you suggested that's a possibility.

Mr. VOLCKER. Did I say an increase in differential?

Senator MITCHELL. You suggested that as a possibility.

Mr. VOLCKER. I meant more than Senator Morgan's bill might provide, which gets pretty small in time. I just don't want to prejudge what might be appropriate.

Mr. JANIS. Senator, I think it's even more than a question of certainty that's at stake here. I think time is needed before the differential is phased out; that time is required because thrift institutions probably are going to be receiving less funds at the deposit window and there's going to be a certain uncertainty about the volume of funds they will receive at the deposit window over the next several years.

A study we have run suggests that there will be about a $42-billion gap per year in the amount of funds received at the deposit window as compared with what will be needed to finance housing. Moreover, it's going to take some time for the thrift institutions to begin to access the secondary market more than they currently are doing. They need the next several years to begin to do that and they need the protection of the differential in the interim.

At the DIDC meetings I recall that one of the members suggested that the differential be phased out immediately. Another member of the committee suggested that it be phased out at the first of the year. Now I disagree with both of those positions because of the reasons I have just stated.

It seems to me that the significance of Senator Morgan's bill is that it would make Congressional intent clear with regard to what it is you want us to do on this differential question. The other members of the committee who suggested the immediate phase-out and the phase-out of the differential on January 1 had very good reasons from their points of view, based on competition I had other reasons, I hope equally good, in terms of protection of housing and in terms of the thrifts' need to access the secondary market. I would hope that Congress will make it clear who's right on that question.

Senator Mitchell. Before asking the others if they want to comment, Chairman Volcker, I would point out to you that if you were serious about the possibility of increasing differentials during this period, Senator Morgan's bill does not prohibit that.

The Chairman. Right. It's not less than.

Senator Mitchell. It's not less than.

Mr. Volcker. It's not less than. OK.

Senator Mitchell. But you can still make it larger.

Mr. Volcker. I didn't read that part of the bill.

Senator Mitchell. Would anybody else care to comment on assessing the relative benefits and advantages of flexibility and certainty? Just like the Army. No volunteers. I have no further questions.

Mr. Volcker. What I would be concerned about, I suppose, in terms of this legislation, is that Congress might legislate but the problem has been that Congress has had great difficulty in reconciling these difficulties itself and, in effect, it turned the issues over to the DIDC. Suppose you run into some situation in the future—and indeed we ran into it in February or March—where farmers were worried about their crops and the ability of banks to finance them. There are competing considerations in the economy for which it is very hard to establish priorities for a 6-year period. So, that's the other side of the coin.

The Chairman. Chairman Janis, Congress determined in 1975 with the passage of Public Law 94-200 there should be a differential between thrifts and banks for categories in accounts created before 1975. We were very explicit that that was it. Now Congress chose not to require a differential for categories for accounts created after 1975. Congress had the opportunity to change that decision several times. We chose not to do so. The decision on the differential is up to you, the regulators. Now why are you so concerned with the quarter point differential between thrifts and banks when the market has established a much higher differential between the yield on market assets and those yields that can be offered by depository institutions? Isn't the real challenge for S. & L.'s the competitive marketplace?

Mr. Janis. Well, yes and no, Senator. I guess what I'm mostly concerned about is future actions of the DIDC. I am concerned about how the differential may be treated with regard to the establishment of new accounts. I think that suggestion has——

The Chairman. Is there anything at all in the legislation or in the conference report or in the legislative history on the floor to indicate that Congress had any intent to apply this differential to accounts created after 1975?

Mr. JANIS. No, there is not such——

The CHAIRMAN. There is none. How can you say—and you argued what the committee did was a violation of congressional intent——

Mr. JANIS. Yes, I think it went against it.

The CHAIRMAN. How?

Mr. JANIS. Because as I read the debates, and as I read the other legislative history, it seemed to me that the differential is a housing differential and it seemed to me that Congress expected that actions with regard to rate decontrol would take place gradually over time, not immediately.

The CHAIRMAN. We had the opportunity again and again and again to apply this to accounts created after 1975 and we decided not to do so and that was what the committee did as I understand it.

Mr. JANIS. Senator, it seems to me that the Congress was telling the DIDC to phase in the new asset powers and decontrol—that's like you have two valves and as you turn one you sort of turn the other, but you time the turning of those valves so everything stays in sync. That's how I read the congressional intent, and I guess everybody reads it differently. I read it in terms of a dovetailing and a careful phase-in over time in order to protect housing and to protect the thrifts during a difficult period of transition. The new asset powers for thrifts won't become useful overnight and profitability won't be improved by those new asset powers for several years. Congress was silent as far as post-1975 accounts were concerned. I think you're exactly right. But I think one has to do more than just read what's in a piece of legislation. One has to try and understand what Congress had in mind.

The CHAIRMAN. I don't argue with the fact that you take that position and it may have been the right position, but it wasn't based on congressional intent or action or legislative history at the time because we explicitly did not take a position on accounts created after 1975.

Mr. JANIS. You left a vacuum as far as post-1975 accounts were concerned.

The CHAIRMAN. We left the flexibility in the judgment of the committee, right.

Mr. JANIS. But I think the overriding theme that you sounded in H.R. 4986 was that of the phase-in. I think that was the whole linch pin of the legislation. Now, of course, you know more about it than I do, but as an observer of the process that's what I understood. Now if I'm wrong, I think——

The CHAIRMAN. The phase-in was a phase-in of the lifting of the rates across the board. That was the phase-in.

Mr. JANIS. But that's looking at micro. That's looking at one piece of it. The whole legislation was based on new asset powers coming on-stream and decontrol coming off. That's what I understand. If I'm wrong, Senator, all I'm saying is that Congress should clarify its intention. I hope that it will. I believe that Senator Morgan has a bill that does just that and I think it does so——

BILL DOESN'T PROVIDE CERTAINTY

The Chairman. Let me ask you about that bill. On page 2, lines 10 and the following, Senator Mitchell was absolutely right, the key in this bill is it doesn't provide certainty. It says the differential shall be not less than 0.25 percent. It can be more. It can be one-half of 1 percent which it was at one time in the past, not less than 0.25 percent. It doesn't phase it out at all unless you prefer to do so. Now if we worked out the "not less than," I think there might be a different attitude on the part of a lot of people toward this bill and then you would have some precision and predictability, but of course you would have absolute rigidity. How would you feel about that? Supposing this bill were modified to knock out "not less than" and make it 0.25 percent by 1981 and 0.20 by 1982 and then you have predictability.

Mr. Janis. Senator, it might improve the bill and it might improve its passage, but I must make a very short philosophical argument to you. I promise you it will be short. That is, there are times when I believe that a higher differential might be in the best interest of the country from a monetary policy point of view. I believe one of the greatest problems we have is the cyclicality in the housing industry. That cyclicality is what is helping to cause inflation. I have supported Chairman Volcker and I continue to do so in his fight against inflation.

The Chairman. That's a very, very helpful response and I think it makes a lot of sense, but look what you're asking for. You want flexibility but only flexibility up, not flexibility down. In all fairness, if you're going to have flexibility, shouldn't you have flexibility both ways? After all, if you're going to say you can make it half a percent, you can make it 1 percent, make the differential whatever you want on the up side, but not on the down side——

Mr. Janis. As I say, what you have suggested may be the best way to draft a bill. It may be the best way to get the bill passed. However, I just must make a point for the sake of the record. Specifically, Congress might want to consider separate and apart rom Senator Morgan's bill, the entire question of a differential hat would be instituted at certain points in time in the housing ycle when housing is about to go into a slump, If housing has too reat of a shortfall in the number of housing starts during a ownturn, I'm worried about the rebound effect that occurs in oming out of a recession, when housing demand hits very hard nd prices go out of sight because manufacturers are geared to roduce to the bottom of the cycle and there are shortages in naterial. I maintain that it's very difficult for Mr. Volcker and the ederal Reserve or anybody to deal with housing's rebound effect.

The Chairman. If you want to key it that much to the housing, houldn't you give the differential to banks that invest in housing?

Mr. Janis. Sure. To me it's not a matter of thrifts versus banks. 's a matter of who's making mortgage loans and I have no probm with the notion of the differential being applied to those that e making some set reasonable amount of loans for mortgage urposes.

The Chairman. Would you include agriculture in that too or just ousing?

Mr. JANIS. I don't know. That's something I can't answer. That's a little bit out of my field.

I would just add this, Mr. Chairman, there may be other ways to protect agriculture. This is something that has been discussed. I'm not sure what the alterative might be, but I think one could consider ways of protecting agriculture through the discount window or other devices that could be created.

The CHAIRMAN. Chairman Volcker, I want to join Senator Garn in his strong, strong protest against the loss of principal a depositor may face because of early withdrawal. I ran into objections in Wisconsin not only from depositors but from bankers who felt that went to the very integrity of their operation, that they would have to enforce a regulation which would require them to take the principal away from people who deposit money at their bank, and you analogy it seems to me completely lacks symetry because obviously if you invest in a bond and interest rates go down you have a capital gain, but here you don't have any capital gains if you withdraw early. I think Senator Garn was right. Most depositors are unlikely to move their deposits around and take advantage of interest rates as much as they are to move their money because they have demands for their money, medical, educational or whatever. They may have to pull it out because of some unforeseen demand and they may have to liquidate the funds they have and if they suffer a penalty in their principal it's something that really annoys people and I can understand very easily why.

Mr. VOLCKER. I can understand the annoyance, and I'm not sure I'm the most vigorous proponent of the action in this particular case, but I don't see it as a moral issue. If somebody wants liquid money, he puts it in a saving deposit or someplace where it's liquid. In the case of a money market certificate, he has a contract for six months and I think the empirical evidence is that during the latest period of rising interest rates the great volume of churning was not caused by people who had some emergency; it was caused by people who felt that if they deposited the money 1 week and 2 weeks later the rate was higher, they would take advantage of that, basically at the expense of the depository institution. I think there's a practical question here, and I can understand the annoyance and irritation, but I don't see it as a moral issue when you put it in those terms.

The CHAIRMAN. Could you understand how people might disagree on that and feel that if they deposit——

Mr. VOLCKER. I can understand how they would be annoyed.

The CHAIRMAN [continued]. Deposit $1,000 in the bank and they have to withdraw that and they are told it's too bad, you don't have $1,000 any more, we will give you $950 because you withdrew it too soon—the feeling is somehow they have been held up, fleeced.

Mr. VOLCKER. I can understand the feeling obviously. Again, there's nothing to prevent a bank from putting in a stronger penalty than what we have required. We are only putting in a minimum.

The CHAIRMAN. My time is up, but let me say the reaction on the part of the bankers is they have never done that. Those that I talked to were very unhappy about having to do that to depositors who they knew so often withdrew it because they had genuine emergency needs for funds.

Mr. **Volcker**. I think there is some disagreement in the banking and thrift world. My impression is—I don't have the tabulation of comments here—that there is strong industry support for the kind of action that the committee took.

The **Chairman**. Senator Morgan. Let me just say, if you would permit, I must apologize. This dog was made in Korea. [Laughter.]

The **Chairman**. But he was processed in——

Mr. **Volcker**. He was distributed from Madison.

The **Chairman**. He was processed in Madison and he contains shredded clippings, probably my old releases.

Mr. **Volcker**. I would like to say that I don't think our committee was violating congressional intent in any way. The one thing Congress didn't want to be very specific about was the differential; they really didn't mention it, except to require it certain reports. There's a long history of congressional debate on this, and the fact that the bill was passed without a specific directive on the differential and that this was left to the committee is significant.

The **Chairman**. Well, my judgment is you're right, but other members of the committee may disagree.

Senator **Morgan**. Mr. Chairman, with regard to what the Congress meant, I think you know that I, for one, have favored and did favor the differential and I did what I could to try to maintain it. I still think that our whole system of financial institutions was a stable one. The banks were doing very well. The thrift institutions were doing very well. But nevertheless, I recognize that the Congress is ready to do away with regulation Q and I accept that fact.

Mr. Janis, I think it was you that sort of described the bill as providing two valves at the same time so it was our intent to do away with regulation Q but at the same time give to the S. & L.'s additional powers to enable them to earn enough money to get more competitive. Were you the one that used that description?

Mr. **Janis**. Yes, sir.

Senator **Morgan**. Those powers included consumer loans up to 20 percent.

Mr. **Janis**. There's a 20 percent of asset limitation.

Senator **Morgan**. What was the purpose of including consumer loans? Why?

Mr. **Janis**. Well, I believe that what Congress had in mind was to make S. & L.'s more competitive, to give S. & L.'s the ability to deal with American households in the kind of one-stop fashion that commercial banks presently deal with American businesses. So, S. & L.'s now will have powers, in terms of credit cards, NOW accounts, trust powers, and consumer loans, that they can use to begin to service the American household in a more comprehensive way. Over time, this will not only increase their earnings but will bring more funds generally into S. & L.'s and will favorably affect housing.

Senator **Morgan**. Well, in your opinion, it had a two-fold purpose? It would give a more comprehensive service to the consumer and also to increase the earnings of the S. & L.'s and thrift institutions?

Mr. **Janis**. Yes, sir.

Senator Morgan. At the present time S. & L.'s are limited in their earning rate by the usury laws of the various States or the Federal Government, are they not?

Mr. Janis. With regard to consumer loans?

Senator Morgan. Yes.

Mr. Janis. Yes.

Senator Morgan. With regard to home loans?

Mr. Janis. Well, of course, usury laws pending to residential first mortgage loans have been preempted except for those States that act within 3 years to reimpose those restrictions.

Senator Morgan. So what is the present maximum home loan rate for home mortgages?

Mr. Janis. The current rate today? The current mortgage rate is just about 12.5 percent.

Senator Morgan. Are there any limitations at all on the maximum?

NO LIMITATIONS

Mr. Janis. None that I can think of.

Senator Morgan. That has not historically been true. Mr. Volcker, do you disagree with that?

Mr. Volcker. Maybe I've forgotten. I thought the Federal preemption——

Mr. Janis. Without usury. If there is no usury statute that a State has enacted or reenacted——

Senator Morgan. Are there no Federal limitations?

Mr. Janis. No, sir. There are no federally applied limitations relative to the mortgage rate. In fact back in March and April the rate actually got close to 17 percent.

Senator Morgan. That's what I'm trying to say. So actually now there are no limitations on interest rates but that has not been historically true?

Mr. Janis. That's right. There were a number of States, between 17 and 22, in fact, which had binding usury statutes.

Senator Morgan. And those usury statutes prohibited that the allowed interest rate was much smaller on the home loans than it was on automobile loans and consumer loans, wasn't it?

Mr. Janis. Yes. I know of one State that had a 10-percent ceiling at a time when the market rate was at 15.

Senator Morgan. Well, Mr. Odom, as the Deputy Comptroller, isn't it true that banks making automobile loans could charge in some cases as high as 25 and 30 percent annual interest rate?

Mr. Odom. I think the restriction on that type of loan is one point over the discount rate, or the State law, whichever is higher.

Senator Morgan. Well, some State laws are allowed to charge more?

Mr. Odom. That's right. That would be with respect to all lending within that State.

Senator Morgan. Isn't it true that consumer loans carried a much higher rate of return than home mortgages?

Mr. Odom. I think that's a fair statement. They are usually more expensive to handle by the institution.

Senator Morgan. And the rate of return was generally higher. Well, now, Mr. Janis, have any S. & L.'s to your knowledge been able to get into consumer loans in the short period of time since the bill was passed?

Mr. JANIS. Well, no. We just put out the consumer loan regulations on proposal last week and we will probably be able to go to final sometime in the fourth quarter.

Senator MORGAN. And in that case, with regard to trust powers, have any of them been able to execute any of the trust powers granted to them?

Mr. JANIS. No, sir.

Senator MORGAN. So none of the new powers granted to the thrift institutions have yet come into being?

Mr. JANIS. That's essentially right, yes.

Senator MORGAN. Now it's my recollection that many of the thrift institutions were not so interested in those powers as they were a more practical mortgage instrument. You heard me say earlier to Mr. Volcker that many S. & L.'s are caught with fixed long-term rates. Is there any work being done on a new practical or more realistic mortgage instrument now for S. & L.'s that would help keep them from getting into the bind that they may find themselves in?

Mr. JANIS. This is something we're considering. Back in April we went to final with the rollover type mortgage which provided some relief in terms of the problems that you have discussed. However, we have received considerable criticism to the effect that the instrument we created is not liberal enough and that there are too many constraints with regard to the flexibility of the instrument. We are in the process of considering the comments and letters that we have received and we will be reviewing the situation to see if further liberalization is justified.

Senator MORGAN. Do you have in your mind any type of—you say further liberalization. Have you anything fixed in your mind yet as to what might be more acceptable to the industry and the consumer?

Mr. JANIS. Well, I can see a few things. One possibility is to allow a graduated type mortgage in combination with an RRM, which would lower the interest level for the typical buyer. This would permit people who have the opportunity to earn at greater evels in the years ahead to have a lower monthly payment during he first couple of years. Another possibility is to make the instrument more flexible by permitting a 1-percent per year increase nstead of the half point percent per year increase that we now ermit. These are things we are considering.

As it's clear that the DIDC is acting to move very quickly on econtrol, it seems to me clear that we would have to begin to onsider more flexible mortgages in order to balance off the rate at which decontrol is and will be taking place.

Senator MORGAN. Even if you do move to expedite it, that would ake some time to feel any of the effects of it, wouldn't it?

Mr. JANIS. Oh, yes. I think when you talk about a rollover mortgage you're talking a minimum of 3 years, probably 5 years, efore a portfolio can be effectively restructured to the point where ottom line profitability can be favorably affected and the institu- ons can become safer and sounder and more viable.

Senator MORGAN. Mr. Volcker, before my time runs out, let me express the concern to you that I——

The CHAIRMAN. Let me just interrupt to say there is a rollcall on the floor. I've finished my questions. I think Senator Mitchell has finished.

Senator MITCHELL. I have a brief comment.

The CHAIRMAN. So what I would like to do, if it's all right with Senator Morgan, is to have Senator Morgan finish his questions and let Senator Mitchell make his brief comment, and whenever Senator Morgan finishes we would recess until 2:30 and hear the second panel at that time. The hour is late and it's a very important panel and we have a number of witnesses.

POSSIBLE HIGHER INTEREST RATES

Senator MORGAN. I only have one more question for the time being. Mr. Volcker, what is the likelihood or prospects for interest rates? The word is being passed around by many financial institutions in North Carolina that as soon as the election is over that the Federal Reserve was going to tighten up or go back to the higher interest rates and some of them say as high as 25 percent. Would you please elaborate? I read what you said the other day.

Mr. VOLCKER. I cannot tell you anything more than what I told you the other day. The election has absolutely no bearing on——

Senator MORGAN. I wasn't here. Do you expect interest rates to go back up?

Mr. VOLCKER. I certainly do not have in mind anything like rates at 25 percent, which would be a total defeat of our anti-inflation effort. Whether interest rates will go lower or whether they will go higher I think is totally in the hands of economic developments and inflationary developments over a period of time. I did say at that time, and I would say again, that you can't expect interest rates to go lower or even to maintain the current level over a period of time if the inflation rate is going to go up. I think that's our major challenge. I'd like to see interest rates move lower. Whether they do or not depends upon what progress we make against inflation.

Senator MITCHELL. I just have two brief comments. I want to join the chairman and Senator Garn in their protest over the penalties of early withdrawal and your rationale, Mr. Chairman, seems to me to be a harsh device to accomplish the purpose intended and I think it could be described as bank robbery in reverse.

I do want to sympathize with you in determining congressional intent. I was a Federal judge and I spent many an evening trying to figure out what Senator Proxmire and others meant by enacting legislation and although the chairman speaks with quite good clarity, it's very difficult and I sympathize with you and I don't agree with what your conclusions are sometimes but I can understand how you can differ on what Congress did mean when it enacted legislation.

The CHAIRMAN. The committee will stand in recess until 2:30.

[Whereupon, the hearing was recessed until 2:30 p.m.]

AFTERNOON SESSION

The **CHAIRMAN**. The committee will come to order.

We're glad to have an excellent panel this afternoon, Edwin Brooks, president of the U.S. League of Savings Associations; Joseph Cugini, chairman-elect of the Credit Union National Association; George Miller, representing the American Savings & Loan League; Lee Gunderson, president of the Bank of Osceola, Osceola, Wis. president-elect, American Bankers Association; John Hutchinson, president of the National Association of Federal Credit Unions; Saul Klaman, president of the National Association of Mutual Savings Banks; and Robert O'Brien, president of the Carteret Savings & Loan, representing the National Savings & Loan League.

I guess we'll just start off with you in that order, alphabetically, with Mr. Brooks going first.

I understand you gentlemen have agreed to confine your opening remarks to 5 minutes.

All right, Mr. Brooks, go right ahead, sir.

STATEMENTS OF EDWIN B. BROOKS, PRESIDENT, U.S. LEAGUE OF SAVINGS ASSOCIATIONS; JOSEPH N. CUGINI, CHAIRMAN ELECT, CREDIT UNION NATIONAL ASSOCIATION; GEORGE MILLER, PRESIDENT, COMMUNITY SAVINGS & LOAN ASSOCIATION, ON BEHALF OF AMERICAN SAVINGS & LOAN LEAGUE; LEE E. GUNDERSON, PRESIDENT, BANK OF OSCEOLA, OSCEOLA, WIS.; PRESIDENT ELECT, AMERICAN BANKERS ASSOCIATION; JOHN J. HUTCHINSON, PRESIDENT, NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS ACCOMPANIED BY RICHARD McCONNELL; SAUL B. KLAMAN, PRESIDENT, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS; AND ROBERT B. O'BRIEN, JR., PRESIDENT, CARTERET SAVINGS & LOAN, CARTERET, N.J., REPRESENTING THE NATIONAL SAVINGS & LOAN LEAGUE

Mr. BROOKS. Mr. Chairman, my name is Edwin B. Brooks, Jr. I am president of Security Federal Savings & Loan Association of Richmond, Va., and appear today as president of the U.S. League of Savings Associations.

We appreciate your courtesy, Mr. Chairman, in inviting our testimony on the actions taken to date by the Depository Institutions Deregulation Committee, the DIDC.

As you know, the U.S. league felt so strongly that the DIDC has acted too rapidly and improperly that we have brought suit to challenge the legality of their rate-restructuring actions of May 28.

Since those actions, we have become increasingly aware of even broader consequences for housing and homeownership.

In my travels, savings and loan managers are asking me whether the Congress and the agencies expect them to continue to perform as the Nation's dependable source of home mortgage credit.

The expanded powers and services of H.R. 4986—most of them still awaiting regulatory implementation by the way— have greatly complicated management's role and are unlikely to make a significant contribution to our badly depleted earnings anytime soon.

Those powers may help us eventually to serve our present savers and borrowers better, but they cannot supplant the housing differential in attracting new funds in 60 days, or 6 months for tha matter.

CONSOLIDATION THROUGH MERGER AND ACQUISITION

With the recession and the complexities of dealing as specialize lenders, with our continual exposure to interest rate risk, we ar pushing our institutions already in the direction of consolidation through merger and acquisition.

Now, the new handicaps imposed by the DIDC on the ability of thrift institutions to attract funds can only accelerate the trend. Under the guise of deregulation, the Government is, intentionally or not, dismantling its reliable and proven system of providing funds for home ownership.

If savings and loans lose their identity, who will take up the slack?

The commercial banking business, the beneficiary of the rate adjustments of May 28, on average, invests less than 10 percent of its assets in home loans.

The big money center banks, only 2 or 3 percent.

The Government itself could assume the home financing role, but few would contend that it is a desirable or efficient alternative.

Mr. Chairman, the most important function these hearings can serve is to begin the debate on whether the Congress is willing to delegate away to the DIDC the future of housing credit.

Do you really wish to leave those housing decisions in the hands of five or six appointed officials, meeting sometimes in the sunshine and sometimes not?

For the present, we recommend strongly that you set some standards, and soon, for the conduct of the DIDC before they undermine further the ability of our home finance specialists to compete for savings dollars.

Senators Morgan, Garn, and Riegle of this committee have recognized the need for immediate statutory direction in S. 2927. This bill explicitly affirms the important role played by the differential during the remainder of the transition period specified by H.R. 4986.

We believe this committee could send an even stronger signal. Specifically, we ask you to mandate a housing differential for all account categories established after December 10, 1975, for the duration of Public Law 96-221; that you define the market rate for those accounts that are market sensitive; and that you direct the DIDC not to establish the minimum ceilings which have built an unnecessarily high floor under mortgage interest rates.

We recommend further a review mechanism to ensure an opportunity for the Congress to maintain its longstanding commitment to decent and affordable housing opportunities for Americans.

This concludes the testimony of the U.S. League.

I look forward to your questions, Mr. Chairman. And I have a complete statement for the record, sir.

[The complete statement follows:]

STATEMENT OF EDWIN B. BROOKS, JR., PRESIDENT, U.S. LEAGUE OF SAVINGS ASSOCIATIONS

Mr. Chairman, my name is Edwin B. Brooks, Jr. I am President of Security Federal Savings and Loan Association of Richmond, Virginia, and appear today as President of the United States League of Savings Associations[1] and its 4,450 member savings and loan associations nationwide.

We appreciate your courtesy, Mr. Chairman, in inviting our testimony at these oversight hearings on "the actions taken to date by the Depository Institutions Deregulation Committee".

In March, President Carter signed the Depository Institutions Deregulation and Monetary Control Act of 1980. For financial institutions, this represented the most significant legislation since the passage of the Federal Reserve Act in 1913.

Various groups had different interpretations of what this legislation would mean during coming years. The news media and general public saw it as a source of new competition and new financial services for the consumer in such areas as NOW accounts and consumer savings deposits.

Savings and loan associations viewed this new legislation as a six-year extension of Regulation Q and the housing differential. Thus, this new law was seen as providing time for the transition of the business into a new services environment. On the other hand, commercial banks saw it as attaining their long sought goal to end the housing differential.

Congress and the housing community saw it as a resolution of many long-term issues that have been debated by commercial banks and thrift institutions over the years.

No one viewed this legislation as having a major immediate impact upon housing. While the law and its legislative history tended to support the efforts aimed at developing new mortgage instruments, neither the savings and loan business nor the housing community saw this legislation as a fundamental alteration in our nation's housing finance system.

Under the new law, it was expected that savings and loan associations, despite their widened powers, would continue to be specialized mortgage lenders. Over the next six years, they would provide new consumer services but not significantly alter their traditional role as the major private market providers of mortgage credit.

To ensure that financial institutions made the transition to paying money market rates on their savings in an orderly fashion, this new legislation created the Depository Institutions Deregulation Committee (DIDC). Congress entrusted this group of federal regulators with the delicate task of moving interest rate ceilings to market rates over a six-year period while taking into consideration not only the safety and soundness of thrift institutions, but also any impact these actions might have on housing.

On May 28th, only 60 days after its creation, the DIDC took actions which far exceeded its six-year Congressional mandate. The committee also made its future intentions clear to the financial sector. It will make every effort to effectively eliminate the housing differential and interest ceilings by early 1981 rather than by mid 1986.

If the May actions of the DIDC are allowed to stand, it means that not only the savings and loan business, but all financial institutions must re-evaluate their futures. Significantly, it also implies that the housing community must re-assess the outlook for housing in the 1980's and beyond.

SAVINGS AND LOAN MERGER TRENDS: BEFORE THE DIDC ACTED

Prior to the May 28th actions of the DIDC, the savings and loan business expected some consolidation over the early 1980's. The new powers authorized by H.R. 4986 will require substantial planning and investment by thrifts. For the next several years the new authorities will provide little, if any earnings, while generating considerable expense. They clearly point toward a new and more complex operating environment for savings associations in the 1980's. Rapid change, increased complexity and higher operating costs would tend to discourage many managers in any business. Thus, it was predictable that a small number of associations would opt out of this new world and simply merge with other, more aggressive and more change oriented institutions.

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[1] The United States League of Savings Associations (formerly the United States Savings and Loan League) has a membership of 4,450 savings and loan associations representing 99⅘ percent of the assets of the $540 billion savings and loan business. League membership includes all types of associations—Federal and state-chartered, insured and uninsured, stock and mutual. The principal officers are: Ed Brooks, President, Richmond, VA; Rollin Bernard, Vice President, Denver, CO; Lloyd Bowles, Legislative Chairman, Dallas, TX; William O'Connell, Executive Vice President, Chicago, IL; Arthur Edgeworth, Director-Washington Operations; and Glen Troop, Legislative Director. League headquarters are at 111 E. Wacker Dr., Chicago, IL 60601; and the Washington office is located at 1709 New York Ave., NW, Washington, DC 20006: (202) 637-8900.

This trend toward consolidation was reinforced early this year by our worst six-month earnings in history.. For the first time on record, the savings and loan business as a whole showed an operating deficit during the second-quarter of 1980.

For the most part, our poor earnings were the result of our new savings structure, particularly the six-month money market certificat(MMC). Our increased exposure to interest-rate-risk over the past ten years has made operating a saving and loan association in a viable manner much more difficult than ever before.

Combined, the shock of HR 4986 and the impact of our new savings instruments on earnings were expected to produce a number of savings associations mergers in the early 1980's. The consensus seemed to be that the business would shrink by about 10 percent by 1985.

Even with consolidation, however, savings associations had expected to remain specialized mortgage lenders. Some expected to emphasize their roles as family financial service centers, while others expected to stress their mortgage banking function. All, however, were to continue what has traditionally been our role, the providing of credit for home mortgages.

THE IMPACT OF THE DIDC

The May actions of the DIDC and anticipated further new actions in the near future have substantially altered the outlook for the savings and loan business in the early 1980's. The DIDC has not only eliminated the six-year transition period to money market savings rates and effectively eliminated the housing differential on savings association six-month MMC's, it has gone much further. We now pay savers rates that exceed market and face "floors" which represent instant experimentation with the absence of rate ceilings. Worse yet, the DIDC threatens to take further actions in the coming months.

In response, associations have already started to reconsider their survival strategies. Without a transition period, savings and loan associations have no hope of developing a viable structure which allows them to pay market rates or higher, do without the housing differential, and still maintain their historic role as specialized mortgage lenders.

During the first-half of this year, there has been 118 mergers and applications to merge by savings associations. These mergers alone, if completed, would set a new record for associations mergers. The previous high was 111 mergers which took place in 1976.

Unfortunately, these mergers are only the tip of the iceberg. Prior to the actions of the DIDC, associations suffered with rapid change and a struggle for earnings. Still, they knew that their role as specialized mortgage lenders was to be preserved.

The past and expected future actions of the DIDC have added a new consideration. It now appears that the DIDC under the disguise of deregulation wants to eliminate specialized mortgage lenders altogether.

In fact, the objective seems to be the creation of a small handful of mammoth but very similar financial institutions.

While this consolidation process will mean that regulators have fewer institutions to regulate, it also means that the decisions over the distribution and the use of credit and other financial resources of these institutions will be in the hands of few large, nationwide institutions controlled by a small number of powerful individuals. The issue of the centralization of the nation's financial power is one to which we would invite the continuing attention of this Committee.

It is fashionable on the part of some these days to say that we should have "free markets" in the operation of financial institutions in this country. It should also be remembered, though, that the last time we had wide-open competition among financial institutions for funds was in the 1920s, and that ultimately helped produce the debacle of the early 1030s. The process of deregulation may well mean many casualties among financial institutions, and we would remind this Committee that failures of financial institutions are much different than other business failures in terms of damage to public confidence and to the orderly function as business and commerce.

We are not talking simply about creating a "free market" for deposit funds in the sense that airline deregulation led to "free market" choices of air routes or that trucking deregulation would lead to fewer constraints in shipping fee schedules. The implications of radically realigning financial institutions—and phasing out specialized institutions—extend into the living rooms of every home owning family in this country.

This pool of mortgage money in our specialized home-financing institutions has been the main support of our residential real estate markets for many decades. It is the reason for the increase in home ownership and home values over the years. Because of it, two out of three American households now own homes or condominiums. And because of this reliable pool of mortgage money at housing-oriented financial institutions, those home owners have been secure in the knowledge that their steadily appreciating home values could be translated into cash if the need arises.

It was to maintain this pool that the housing differential was established when thrift institutions were brought under Regulation Q controls in 1966.

And make no mistake about it, the housing differential is the main factor responsible for the continued flow of mortgage money to home buyers in the post-1966 period, a period characterized by rampant inflation and, increasingly, sharp fluctuations in interest rates.

Without the differential, money would have been drawn out of home-lending institutions and the into commercial banks. There are many more commercial bank offices than thrift institutions offices—and banks have always had broader authority than thrifts to serve customer needs.

Authority to better serve customers was provided through new powers in a limited measure in Public Law 96-221. But implementing regulations for many of these powers have not been issued in final form. Also, we cannot under the law begin offering NOW accounts nationwide until next year. In any event, all these new powers do not put savings and loan associations on a totally equal footing with commercial banks.

Let me also emphasize that we have never regarded the new powers granted under HR 4986 as a substitute for the differential. As we repeatedly advised this Committee and the Congress, given a choice between those new powers and the differential—then or now—this business unhesitatingly would choose preservation of the differential. We had no desire for NOW accounts. We had little enthusiasm for the consumer loan business. We did not put a high on issuance of credit cards. These are the three new powers that will cause our institutions to resemble the commercial banking business.

While these new powers will enable our business to provide useful additional services to our customers, our expertise and preference, not to mention the existing tax laws governing our institutions, indicate that it will be a long time before our institutions will want to or indeed be able to move away from the residential mortgage field. We have never had any desire to become quasi-banks or near-banks or full-service banks. We have been organized as housing institutions. That is where we hope and plan to continue operating, and we think that doing so is in the best interest of American homeowners, present and future.

The DIDC was created after many years of deliberation by Presidential commissions and by the Congress on the role of financial institutions. Throughout those discussions, it was quite clear that there were serious problems with our institutions attempting to live in an environment characterized by serious inflation and extraordinarily high interest rates. In the end, the Congress decided that the way for our institutions to cope and live in this kind of environment was the granting of some additional powers. Probably the wisdom of that decision is open to question. Frankly, instead of new powers, we would have been much happier to see a more realistic, more practical mortgage instrument which would enable us to adjust more easily to all phases of the interest rate cycle.

Clearly, the new consumer lending and transaction account powers are no replacement for the differential.

If you take away the housing differential—and abort the flow of funds to the pool of mortgage money—what are the alternatives for the home buyers of this country?

The record shows that while specialized financial institutions have provided year-in, year-out support to home buyers, other types of financial institutions have been fair-weather friends. Currently savings associations hold $393 billion in one-to-four-family home mortgages, more than all private financing sources combined. Our share is 55 percent of all private home loans outstanding—and this compares with only 30 percent in 1950, when the great postwar housing boom was just starting.

But while the savings and loan share of the one-to-four family market rose from 30 to 55 percent between 1950 and now, the commercial bank share has actually dropped—from 22 percent to about 21 percent. The dedication of the savings and loan business to housing is shown even more clearly by the proportion of our assets used for mortgage lending. Nearly 68 percent of our total assets are in home mortgages, compared with only 10 percent for commercial banks.

While other institutions may take up some of the slack, clearly no other private lending sources would be in a position to fill the vacuum if we didn't have an effective housing differential.

Because of the currently high level of interest rates, much housing is now financed through mortgage revenue bonds, but this, of course, is at the cost of revenue losses to the U.S. Treasury—and ultimately this loss is being borne by all taxpayers. Moreover, it is clear to us that public bond issues cannot be relied on to finance the massive housing needs of the 1980's.

The choice comes down to maintaining the housing differential—or allowing the pool of money for home buyers to get smaller and smaller. We believe the latter choice would be a major step backward—and a tragic decision not only for housing and tomorrow's generations of home buyers, but for all Americans who now own homes or condominiums.

Without this pool of mortgage money, people selling homes would have a harder and harder time finding buyers. Ultimately all home values would decline. In short, removing the differential precipitously would jeopardize the financial standing of the two out of three American families that own homes or condominiums—in most cases, the most valuable asset they will ever own.

And certainly the other reasons for maintaining this pool of home fiancing funds are as compelling as ever.

Future demand for housing will be overwhelming—and impossible to meet if we abandon the long-standing commitment to housing finance. During the 1970's and for the next 15 to 20 years, record numbers of people have been and will be moving into the 30-and-over age brackets, the years when most people start thinking about buying homes.

Between 1950 and 1960, the decade of the great postwar housing boom, some 24 million Americans reached age 30. This fell to 23 million in the 1960's and rose to an estimated 32 million in the 1970's. In the 1980's this is expected to swell to 43 million persons, or nearly one-third more than in the 1970's.

Future housing demand is also being swelled by the broadening base of home ownership. Singles—and especially single women—as well as other nontraditional home buyers have become significant forces in the market. This trend is expected to continue.

We also need private housing funds to rehabilitate and revitalize our older housing stock. Even before the energy crisis, it had become obvious that our existing housing stock was too valuable a national resource to be wasted. Rising energy costs now make it even more essential to preserve and restore housing in older, close-in locations, whether in big cities or small towns.

To be effective in maintaining this pool of money for future home-buyers, however, rate ceilings—including the housing differential—must be established at realistic levels. If they are set so high that thrift institutions are not able to pay the maximum savings rates, it would be no better than having no differential at all.

In your invitation to present testimony at these hearings, Mr. Chairman, you asked for our views on S. 2927, the bill introduced last month by Senator Morgan along with Senators Garn, Riegle, Chiles, Domenici, Ford, Young, and Hayakawa.

The U.S. League and, I believe, all who are genuinely concerned about the future of the housing sector of the economy were encouraged by the introduction of this bill because it signified strong support on this committee for the notion that the DIDC went too far, too fast in carrying out its assignment under Public Law 96-221. Even though the technique for retaining the differential in this bill differs with our approach, we welcomed this indication of Congressional concern for housing. We interpret the bill as an objection to the notion that a newly created regulatory agency could suddenly and unilaterally shift the housing policy of this country 180 degrees. We have never doubted that the intention of Congress is to assure a continuing availability of affordable mortgage money to American families by the most efficient, equitable means possible.

But it was important that such a concrete expression as this bill reinforce that intention directly. The bill explicitly recognizes the need for a housing differential during the transition period set forth in Public Law 96-211. Recognition of this need was evident throughout the long deliberations on H.R. 4986 and in our view was incorporated in the Conference Committee's report. But this Congressional intent has been virtually ignored by the DIDC.

We believe the bill could be an even stronger signal that Congress is reaffirming the nation's commitment to home ownership opportunities at affordable levels for all Americans.

Specifically, we suggest that the Committee consider amending the bill so that the following standards are established for the future activity of the DIDC during the duration of Public Law 96-221.

Recommendation No. 1: Ceilings on any deposit or account (under $100,000) created after December 10, 1975, for the duration of the six-year continuation of rate control mandated by Public Law 96-221 (HR 4986): (a) shall have a housing differential; (b) shall not exceed the free market rate as defined by Treasury instruments of similar authority; and (c) shall not be subject to "minimum ceilings" or "floors". (Note: Public Law 96-221 preserves the statutory differential for account categories in existence in December, 1975.)

Secondly, we remain concerned by the procedures used in the Deregulation Committee. Their decisions affect fundamentally the health of our national economy and, as such, deserve the continuing oversight of this Committee and the Congress. To assure that result, we further propose:

Recommendation No. 2: Any decision of the DIDC that affects rate ceilings or terms of accounts now in existence or created during the six-year life span of Title II of Public Law 96-221 shall not take effect for at least 60 days following promulgation to permit either House of Congress to review the action and approve or disapprove.

Because of their actions to date, we are gravely concerned that the DIDC, in the absence of explicit directions from Congress, could remove the housing differential on all savings instruments by such means as creating an entirely new set of savings instruments having no rate ceilings at all.

It is the strong possibility of this kind of future adverse actions that we believe makes it especially important, for Congress to spell out as precisely as possible the extent to which the housing differrntial is to be preserved over the coming six years.

Under present financial market conditions, at least a one-quarter per cent housing differential is fully justified, in our view.

In closing, Mr. Chairman, I would like to reiterate what we consider the central matter of concern before your Committee.

An agency created by Congress to assure a smooth transition toward the removal of rate controls has twisted that assignment beyond recognition so that instead it is effecting the elimination of a system of specialized home finance institutions and an abrupt and complete abandonment of the nation's commitment to housing.

And it is carrying out this self-assigned mission without consultation of Congress or the American people.

We believe that decisions with consequences of the magnitude that DIDC actions are having—consequences which threaten two thirds of America's families—should be made only after a thorough national debate and only by those who truly represent the broadest interests of all the people, the Members of Congress.

The CHAIRMAN. We appreciate that, sir.

Mr. Cugini.

Mr. CUGINI. Mr. Chairman, if I may, I'd like to clear up a case of mistaken identity.

As I broke for lunch, I heard several people mention the dog that you had on the dais this morning was a cocker spaniel. For the record, it was a credit union, St. CUnard.

Mr. Chairman, members of the committee, my name is Joseph N. Cugini. I am the chairman elect of the Credit Union National Association, president and general manager of the Westerly Community Credit Union, a State chartered credit union in Westerly, R.I.

CUNA appreciates this opportunity to participate in these oversight hearings on the actions of the Depository Institutions Deregulation Committee.

CUNA has long opposed interest rate controls because of their anticonsumer nature. We have testified many times before Congress that savers are entitled to a market rate of return on their funds. And the best means of assuring such a return is the ability of all financial institutions to charge a fair, but market rate for loans.

At the association's annual meeting in May, CUNA adopted a resolution seeking increased share rates from NCUA. With regard to S. 2927, which would congressionally mandate the phase out of rate controls, CUNA believes that the important fact is not how, but when controls are eliminated.

Whether the DIDC or Congress does the job is unimportant to credit unions. What is important to consumers everywhere is that the job be done as quickly and economically as is feasible. In short, it is imperative that the 6-year elimination of controls not become a 6-year extension.

The DIDC's first official act, issuing a proposed premium regulation, drew a chuckle from the financial community. The deregulators were issuing new regulations. But that first action, in CUNA's opinion, points up a serious flaw in the operations of the DIDC to date. That flaw—perhaps the result of enthusiasm to get the job done—results from lack of planning, a failure to weigh the impact of deregulation on the financial institutions being deregulated, on the public, and on other segments of the economy.

For example, in early June, the DIDC adopted a rule, once again without public comment, applicable to commercial banks, mutual savings banks, and savings and loan associations, which would increase the early withdrawal penalties on time deposits.

The significance of the changes was that it is now possible for the imposition of the penalty which is mandatory to result not only in the loss of all interest, but also a reduction of principal returned to the depositor.

And the NCUA, not being bound by this action, decided to seek public comment on this issue.

OPPOSE INCREASED PENALTIES

CUNA will be filing a comment opposing the proposed increase of the early withdrawal penalties. From a strictly business viewpoint, the increased penalties are attractive because they would discourage the early cashing in of share certificates and any penalty is paid to the financial institution.

However, a credit union combines a business orientation and consumer orientation. The DIDC has indicated it was increasing the penalties to make it less attractive for depositors to withdraw time deposits early in the contract period, particularly in times of rapidly rising interest rates, such as occurred during the first quarter of 1980.

We do not recall seeing any documentation on how much of a problem this really was earlier this year.

Moreover, a depositor/member may also be pressured to withdraw funds due to unforeseen circumstances, such as a medical emergency.

The penalties prescribed are mandatory, so the financial institutions would have no choice but to impose them. We feel the current penalties provide an adequate disincentive for withdrawal under most all circumstances. Therefore, we are glad to have an opportunity to convince NCUA not to follow the DIDC's action on this matter.

The DIDC currently has under study a proposal to establish uniform rates on transaction accounts in different financial institutions.

Mr. Chairman, credit union members currently have some $1 billion in their share draft accounts. Cutting the rate on these accounts from 7 to 6 percent would create a loss to these shareholders of some $5 million.

Further, such action would discourage other credit unions from getting into the share draft program, and hamstring the growth of the existing programs.

The congressional mandate for parity between the share draft and NOW account means, in our opinion, that the best interest of the consumer should be served by such parity. That translates into raising the NOW account rate, rather than lowering the share draft rates.

The DIDC's mission is to phase out—deregulate—interest rate controls.

We have been surprised to see DIDC expend its energy on increasing regulations on pots and pans and early withdrawal penalties.

These oversight hearings can serve a very important function if they result in Congress restating to the DIDC what Congress intends the DIDC's purpose to be.

Mr. Chairman, the DIDC has lost its congressional compass. Its actions, to date, have been of a regulatory rather than a deregulatory nature.

A proposal like the Committee's early withdrawal penalty hurts the consumer and puts financial intermediaries in a worse position vis-a-vis nonfinancial intermediaries, such as money market mutual funds, than banks and S. & L.'s were in before the DIDC.

While we do not believe it is necessary that the DIDC be condemned to the extinction with which it threatened the premium industry, we do believe Congress needs to set the Committee back on its proper course.

Before acting again, the DIDC should carefully plan and evaluate the costs and compliance burden of its actions on both financial institutions and consumers. In phasing out rate controls, it must balance the needs of both the saver and the lender. Irreparable harm to either would benefit no one.

The DIDC needs a clearcut, well thought out plan to accomplish the phaseout of rate controls on time and savings deposits over the next 6 years. These targets are of immediate importance, so that financial institutions can begin to plan now for the journey to a Q-less world tomorrow.

Failure to take the complexity of the task into account will only penalize the small financial institutions least able to quickly change.

If, Mr. Chairman, the DIDC's congressional compass cannot be successfully recalibrated—and only the future can tell us that—CUNA will strongly urge that the committee be scuttled.

Mr. Chairman, that concludes my remarks. I'll be glad to answer any questions.

[The complete statement follows:]

STATEMENT OF THE CREDIT UNION NATIONAL ASSOCIATION, INC., ON DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

(CUNA is a national association of credit union leagues representing each state and the District of Columbia. Through the leagues, CUNA represents more than 20,000 Federal and State-charted credit unions serving more than 40 million members.)

Mr. Chairman, members of the committee, my name is Joseph N. Cugini. I am Chairman-elect of the Credit Union National Association, Inc. (CUNA), and President and General Manager of Westerly Community Credit Union, a state chartered credit union in Westerly, Rhode Island. CUNA appreciates this opportunity to participate in these oversite hearings on the actions of the Depository Institutions Deregulation Committee (DIDC).

The DIDC is a creature of Public Law 96–221. It was established with the purpose of phasing out interest rate controls on the time and savings deposits of commercial banks, savings and loans associations and mutual savings banks. DIDC also was given the task of eliminating the differential—the higher rate thrifts have been able to pay since 1966—on savings.

Congress mandated that the DIDC should accomplish this task within six years, at which time the DIDC would be disbanded. The Federal legislature set targets for the phase-out, but allowed the DIDC freedom to miss these targets if it was felt, for economic reasons, that too hasty abandonment of interest rate controls would be detrimental to the institutions involved.

Members of the DIDC, an evolutionary end product of the Interagency Coordinating Committee created by executive order under President Lyndon B. Johnson, include the Chairmen of the Federal Reserve Board, Federal Home Loan Bank Board, Federal Deposit Insurance Corporation, National Credit Union Administration Board, the Secretary of the Treasury and the Comptroller of Currency. The Comptroller, as an arm of the Treasury, has no vote. NCUAB is the only voting, financial institutions regulatory agency not bound by the interest rate decisions of the DIDC.

THE HISTORY

For some 12 years, the Interest Rate Control Act, commonly called Reg. Q, was extended by Congress. It granted, as we have noted, the thrift industry a rate advantage on savings. Orginally applied only to passbook accounts, the differential has been applied to time deposits, more specifically, money market type accounts. The purpose of the differential was simple—to insure an inflow of funds to thrift institutions that would assure the availability of funds for home loans.

But even before the first imposition of the differential by Congress, the nation was looking at ways to transform financial institutions. President Kennedy commissioned the Heller Commission to look into modernizing the powers of the nation's financial institutions, which had remained essentially unchanged since the 1930's. The Heller Commission was followed by the Hunt Commission. The Hunt Commission recommendations spawned the Depository Institutions Deregulation and Monetary Control Act of 1980.

During this time, the services financial institutions were providing were changing to meet the needs of a public that was rapidly becoming financially more astute, and a technology that was changing traditional ways of handling financial transactions. The credit card was providing plastic money. Technology was moving toward replacing the paper check with the electronic transaction.

Consumers attitudes too were changing. People wanted to earn a return on all funds they kept in their financial institutions, but were prohibited from doing so by laws essentially established to prevent a repetition of the unfettered completion which many Great Depression economists and legislators believed had caused the bank holidays of the 1930's.

To circumvent these 40-year-old laws, innovative bankers, thrift officials and credit union managers were creating new services. The inflationary spirals of the later 1970's, coupled with competition among financial institutions for the dollars of an increasingly more financially sophisticated public, increased the pressure for change. Credit unions began providing interest-earning share drafts. Banks offered the same service in the form of automatic transfers from savings to checking accounts. The thrift industry embarked upon a variety of telephone and other automatic bill-payer plans.

MONETARY POLICY

All of these new services blurred traditional distinctions in the nation's money supply. Given share drafts, automatic transfers from savings to checking, and a variety of different bill year payer accounts, the distinctions between demand and time deposits became very unclear. Also, during this same period, the Federal Reserve Board—the nation's central bank—was losing members. Control of the reserves of these banks, many economists believe, is essential to the conduct of sound monetary policy. The exodus of FRB members, coupled with the inflation of the mid and late 1970's, led some to fear that the FRB was rapidly losing the ability to control monetary policy.

THE SAME SAVER

Traditional values which led consumers to save were being replaced in the 1970's with a buy-now-pay-later-in-cheaper-dollars mentality as inflation reached double digit proportions. Financial institutions, limited by archaic usury laws on lending and savings, were prohibited from paying a market rate of return on regulated time and savings accounts. New, unregulated financial intermediaries stepped into the void, offering money market rates for funds that were also accessible by check. Money began flowing out of financial institutions into these intermediaries.

At the same time, and for the first time, the private sector was forced to compete with the public sector for funds. With the introduction of the money market certificate for financial institutions in the late 1970's, financial institutions found themselves competing with the government for the consumers' savings dollar. The advent of the money market certificate at financial institutions made the general public aware for the first time of something that previously was the preserve of the financially sophisticated, the Treasury bill.

Small savers, now abundantly aware of the financial advantages only available to those with large sums of money, found their voice. Equity and the need for captial formation required that voice be heard.

CONGRESS ACTS

The 95th and 96th Congress transformed the study of a decade into legislative reality with a number of measures that moved the nation's financial institutions from the decade of the 1930's to the decide of the 1980's. These legislative accomplishments, which granted financial institutions modern powers such as the ability to pay consumers fair rates of return on their all funds, and which swept aside out moded usury laws, are aimed at making banks, thrift institutions and credit unions compete—to the consumers benefit—for savings and lending business.

To many, this so called homogenization of financial powers, makes less clear the distinction between the long established roles of thrifts, commerical banks and credit unions. Thrifts have been granted broadened consumer lending powers and credit unions broadened mortgage lending powers. And all financing intstitutions have been granted traditional commercial bank checking powers, with a twist that benefits the consumer—the ability to earn interest on these accounts.

CUNA does not believe that powers differentiate financial institutions but that philosphy does. Consumer powers, in our opinion, will not turn thrifts from their primary function of lending for home mortgages, nor will share drafts or mortgage lending erode the cooperative nature of the member-owned and operated credit unions. The beneficiary of these changes will be first, the consumer, second, the financial institution and third, the nation through capital formation. In addition, the enhanced ability of the nation's central bank to conduct monetary policy will benefit all of us.

THE CU POSITION

CUNA has long opposed interest rate controls because of their anti-consumer nature.

We have testified many times before Congress that savers are entitled to a market rate of return on their funds and the best means of assuring such a return is the ability of all financial institutions to charge a fair, but market rate for loans. At the Association's annual meeting in May, CUNA adopted a resolution seeking increased share (savings) rates from NCUA.

With regard to S. 2927, which would Congressionally mandate the phase-out of rate controls, CUNA believes that the important fact is not how, but when controls are eliminated. Whether the DIDC or Congress does the job is unimportant to credit unions; what is important to consumers everywhere is that the job be done as quickly as economically feasible. In short, it is imperative that the six year elimination of controls not become a six year extension.

DIDC ACTIONS

The DIDC's first official act—issuing a proposed premium regulation—drew a chuckle from the financial community. The derregulators were issuing new regulations. But that first action, in CUNA's opinion, points up a serious flaw in the operations of the DIDC to date. That flaw, perhaps the result of enthusiasm to get the job done, results from lack of planning—a failure to weigh the impact of deregulating on the financial institutions being deregulated, the public and other segments of the economy.

The Congressionally mandated life of the DIDC is six years. At the end of this period the premium regulation-action on which has been postponed until next year—would be meaningless. Without interest rate controls, premiums would have once again been available at financial institutions. The premium proposal was issued, in our opinion, without data indicating widespread abuse by financial institutions, or the impact it would have on the multi-million dollar premium industry and the thousands it employs. As a point of information, NCUA at the time of the proposal, indicated it had received no complaints of CU abuse with regard to premiums.

The Committee's next action dealt with the thorny problem of the differential on 6 and 30 month certificates. Unlike the premium proposal, the CD proposal was not even issued for public comment; it was just finalized.

The floor-ceiling formula developed by the Committee for determining when the differential on these accounts was and was not in effect would baffle some of the most sophisticated financial experts, to say nothing of causing confusion among the public. NCUA, as Public Law 96-221 fortunately allows, chose not to follow the DIDC's lead. Instead the agency issued a more simple set of certificate rules that established a 9½ percent ceiling on share certificates, the maturity of which the CU was left to establish.

In early June, the DIDC adopted a rule, once again without public comment, applicable to commercial banks, mutual savings banks and savings and loan associations which would increase the early withdrawal penalties on time deposits. The significance of the changes was that it is now possible for the imposition of the penalty (which is mandatory) to result, not only in the loss of all interest, but also a reduction in the principle returned to the depositor. The NCUA, not being bound by this action, decided to seek public comment on this issue.

CUNA will be filing a comment opposing the proposed increase in the severity of early withdrawal penalties. From a strictly business viewpoint, the increased penalties are attractive because they would discourage the early cashing in of share certificates, and any penalty is paid to the financial institution. However, credit unions combine a business orientation and a consumer orientation. The DIDC indicated that it was increasing the penalties to make it less attractive for depositors to withdraw time deposits early in the contract period, particularly in times of rapidly rising interest rates such as occurred during the first quarter of 1980. We do not recall seeing any documentation on how much of a problem this really was earlier this year. Moreover, a depositor/member may also be pressured to withdraw funds due to unforseen circumstances, such a as a medical emergency. The penalties prescribed are mandatory, so the financial institution would have no choice but to impose them. We feel the current penalties provide an adequate disincentive for withdrawal under most all circumstances. Therefore, we are glad to have an opportunity to convince NCUA not to follow the DIDC's action on this matter.

The DIDC currently has under study a proposal to establish uniform rates on transaction accounts in different financial institutions. When the DIDC staff first presented options to achieve this goal to the DIDC in late June, the staff paper presented a variety of options—all of which included a decrease in the interest rate ceiling credit unions could pay on their share draft accounts. However, when the option paper was published in the Federal Register for public comment, we noted that all references to credit unions and share drafts had been deleted and the proposal now addressed only transaction accounts at commercial banks, mutual savings banks, and savings and loan associations. We assume that these deletions were made because the staff acknowledged that DIDC actions do not effect credit unions. Moreover, we feel that such a deletion was inevitable because of the recognition that such an action would be contrary to deregulation.

Mr. Chairman, credit union members currently have some $1 billion in their share draft accounts. Cutting the rate on these accounts from 7 to 6 percent would create a loss to these shareholders of $5 million. Further, such action would discourage other CUs from getting into the share draft program and hamstring the growth of existing programs. The Congressional mandate for parity between the share draft and the NOW account means, in our opinion, that the best interest of the consumer should be served by such parity. That translates into raising the NOW rate, rather than lowering share draft rates.

This discussion of the actions of the DIDC has a negative tone. CUNA has very positive feelings about the role of the DIDC, those who comprise it, and the ultimate benefits that accomplishing its mission will provide the consumer, especially the small saver.

However, the DIDC's mission is to phase out—deregulate—interest rate controls. We have been surprised to see DIDC expend its energy on increasing regulations on pots and pans and early withdrawal penalties. These oversight hearings can serve a very important function if they result in Congress restating to the DIDC what Congress intends the DIDC's purpose to be.

WHAT CAN BE DONE

To be successful in its mission, the DIDC need only to follow the guidelines laid down in Title VIII of Public Law 96-221, the Financial Regulation Simplification Act.

The Act states that the need and purpose of any regulations issued should be established. Adherence to this principle would have killed the proposed premium regulation, as there was no firm evidence of any widespread abuse that warranted its issuance.

Another section of the Act states that the cost, paperwork and compliance with regulations, as well as their impact on consumers and financial institutions, should be taken into account before a regulation is issued. CUNA believes that a cost analysis of any regulation the DIDC contemplates, which would cost the financial institutions it regulates or the consumer more than $500 million over five years, should be mandatory. Along these lines it is important, in our opinion, that the interest rate projection of the DIDC and its predecessor the ICC, be reviewed so a determination can be made of the cost of the rate changes to a financial institutions resulting from these projections.

The Regulatory Simplification Act also calls for timely participation and comment on regulations by government and the public. This rule was not adhered to in the case of the DIDC's CD rule. Had it been we might not be here today and the complexity of those regulations may well have been simplified in a manner that would make them more beneficial to both the financial institution and the consumer. Even if there were a compelling reason for denying public comment on the CD proposal, it would not have been so Rube Goldberg in nature had the DIDC drafters complied with the Regulatory Simplification Act's instruction to write regulations that are simple, clearly written and understandable to those that must comply with them.

CONCLUSION

Mr. Chairman, the DIDC has lost its Congressional compass. It's actions to date have been of a regulatory rather than a deregulatory nature. Proposals like the Committee's early withdrawal penalty hurts consumers and put financial intermediaries in a worse position vis-a-vis non-financial intermediaries, such as money market mutual funds, than banks and S&L's were in before the DIDC.

While we do not believe it is necessary that the DIDC be condemned to the extinction with which it threatened the premium industry, we do believe Congress needs to set the Committee back on its proper course. Before acting again, the DIDC should carefully plan and evaluate the costs and compliance burden of its actions on both financial institutions and consumers. In phasing out rate controls, it must balance the needs of both savers and lenders. Irreparable harm to either would benefit no one.

The DIDC needs a clear cut, well thought-out plan to accomplish the phaseout of rate controls on time and savings deposits over the next six years. These targets are of immediate importance so that financial institutions can begin to plan now for the journey to a Q-less world tomorrow. Failure to take the complexity of the task into account now can only penalize those small financial institutions least able to change quickly.

If, Mr. Chairman, the DIDC's Congressional compass cannot be successfully recalibrated—and only the future can tell us if it can—CUNA would strongly urge that the Committee be scuttled.

Mr. Chairman, that concludes my remarks. I would be glad to answer any questions. Thank you.

The **Chairman**. Thank you, Mr. Cugini.

Mr. Gunderson.

Mr. **Gunderson**. Yes, Mr. Chairman. I, too, was disappointed that that little fellow wasn't made in Wisconsin even though it was donated by our friends from the credit unions.

The **Chairman**. The banker bear was manufactured definitely—it says so—in the United States.

Mr. **Gunderson**. Mr. Chairman, I am Lee Gunderson. As president-elect of the ABA, we do appreciate the opportunity to present the views of America's full service banks on the recent activities of the Depository Institutions Deregulation Committee.

Our written statement focuses on seven major areas relating to the organization and rulemaking activities of DIDC.

In summary form, I'd like to highlight it for you in the context of our statement.

First, we do want to express our continuing support for the rationale of deregulation, as provided in Public Law 96-221. It is our view that the process of deregulation must proceed with all deliberate speed in order to permit all regulated financial depositories to serve the financial needs of the American public, which has increasingly become aware of the attractive financial services offered by less regulated depository intermediaries.

This committee correctly identified the reasons necessary for deregulation legislation in its report accompanying H.R. 4986 when it stated that the present structure cannot fulfill the temporary mandate given in 1966 to regulation Q to provide an even flow of funds into housing.

Regulation Q addressed only fund flows between commercial banks and thrift institutions, and market forces have made this intramural war irrelevant.

It's clear that regulation Q and its mandate of below-market rates to small savers is driving money out of the financial system, out of housing, and into noninsured Federal intermediaries.

Second, on the issue of the organization of DIDC, we believe the congressional decision to transfer the authority to send interest rate deposits to a six-member Depository Institutions Deregulation Committee was fair and equitable.

We believe in the integrity of the individuals serving on the committee, and it is our judgment that the committee's constitution is not biased against the interest of commercial banks, thrift institutions, or the housing industry.

Third, we'd like to put into proper context DIDC's May 28 decision. The simple, unavoidable fact is that all the deregulation did on May 28 was to allow the rules for 6-month money market certificates of deposit, which had been in effect for almost a year, to continue in effect, though in a very limited, complex way.

The rule in no way causes funds to flow out of thrift institutions into banks. In fact, the only market effect of the rule was avoidance of a massive drain of deposits from banks into thrift institutions in the short term.

With respect to the small saver, 30-month certificate, the Deregulation Committee established a minimum ceiling of 9¼ percent for banks and 9½ percent for S. & L.'s and mutual savings banks, and raised the schedule of interest payable by 50 basis points between the minimum and maximum ceilings.

MISCONCEPTION AGAINST THE DIDC

A misconception directed against the DIDC is that it has placed a floor on the interest rates payable on money market certificates. This characterization is completely erroneous.

The regulators are not setting the rates institutions must pay; they are setting them a maximum permitted rate.

We believe the May 28 decision of DIDC is fully justified in view of the competitive pressures facing all depository institutions.

It must be recognized the real competition to savings and loans comes not from commercial banks but from the unregulated, nondepository institutions. Last week $750 million more flowed into money market mutual funds, to a total of $80.7 billion. That's 15 straight weeks in a row that it's increased.

The decision of the committee clearly conforms the direction of the law to provide for a phaseout of regulation Q just as soon as possible.

The committee is not bound by any target. It may exceed the target if economic conditions warrant.

It is unfortunate how some members of the thrift industry have attempted to equate the solution of the recent recession within the home building and real estate industries with their self-protectionist arguments about market rates and the differential.

The thrift lobby has never leveled at the housing industry about the economic reality. Funds held by the banks are fungible so far as investment in housing is concerned.

Claims that one-quarter percent differential will solve the housing problem are absurd. They are predicated on the notions that money in banks will not go into housing—it does in greater number each year—and that some special commitment to housing, a commitment which S. & L.'s and the mutual savings banks have both been moving away from for years, entitles them to anticompetitive advantages.

Finally, such claims belie the fact that the American saver is well aware of the investment opportunities available in the money markets outside of regulated depository institutions.

I would also like to comment briefly on our position on S. 2927 today. The issue that is at the center of the current dispute between banks and thrift institutions over the May 28 decision of DIDC is the matter of the differential on money market certificates.

Certainly our position of the question of rate differentials on any type of deposit is quite clear. We did, however, compromise on this issue by supporting Public Law 96-221, even though it mandates continuation of the differential on those types of accounts in existence on December 10, 1975, for a 6-year period.

We believe that the imposition of a differential on the money market certificate or on any other newly created type of deposit will be counterproductive and represents a direct contradiction to the spirit of the Depository Institutions Deregulation Act.

We oppose S. 2927 as a step backward, because it would weaken the ability of the DIDC to create a more competitive and balanced financial environment a scant 5 months following the committee's creation.

We have some added written testimony, and I'd be very happy to espond to any questions that any members of the committee might have.

[The complete presentation of the American Bankers Association ollows:]

TESTIMONY
OF
LEE E. GUNDERSON
on behalf of
THE AMERICAN BANKERS ASSOCIATION

I am Lee E. Gunderson, President of the Bank of Osceola, Wisconsin and President-Elect of the American Bankers Association. We appreciate this opportunity to present the views of the American Bankers Association, the major banking trade association whose membership includes more than 90% of the more than 14,000 full service banks in this nation.

These hearings are being held to discuss the actions taken by the Depository Institutions Deregulation Committee, created pursuant to P.L. 96-221. Also, these hearings will consider S. 2927, legislation sponsored by Senators Garn, Morgan and Riegle of this Committee, among others, which would limit the authority of DIDC by prescribing a phase-out of the existing one-quarter percent differential on a rigid 6-year formula and mandating new statutory differentials between thrift institutions and commercial banks for accounts created since December 10, 1975.

Mr. Chairman, our testimony today will focus on the following seven areas: (1) ABA's continuing support for the rationale of deregulation as provided in P.L. 96-221; (2) ABA's view that the organization of DIDC is fair and equitable from the perspective of all affected interests; (3) ABA's belief that banks should continue to have the prerogative to offer premiums to attract deposits; (4) ABA's assessment of DIDC'S May 28th decision, as a fundamentally correct economic decision, but this is only the tentative, smallest possible step toward eventual deregulation of deposit rate ceilings; (5) ABA's recommendation that DIDC improve the procedural methods for its decision-making process; (6) ABA's analysis that the downturn in the housing market, as well as its recent upswing, are not related to DIDC's May 28th decision; and (7) ABA's opposition to legislation such as S. 2927 as a step backward in the process of moving away from a regulated, artificially controlled government market, toward an environment where all depository institutions will have the opportunity to offer their customers market rate yields on their savings deposits.

Rationale for Deregulation

The Deregulation Committee (popularly known as DIDC) is charged with the difficult task of unraveling the complex structure of deposit interest rate ceilings. As this Committee is well aware, the legislative decision on how to reform our financial institutions was a process involving the deliberations of the last three Congresses and included the support and policy recommendations of the past three Administrations.

The product of your work, P.L. 96-221, is a consensus among many points of view and, as such, is a compromise. Our Association, for example, would have preferred to have had an immediate termination of the interest rate differential, which discriminates against bank customers, along with the phase-out of the Interest Rate Control Act over a more accelerated period than the Act's six-year term.But, we supported, as did the trade associations of the thrift industry, the enactment of the deregulation legislation for most of the reasons cited in the

Senate Report accompanying H.R. 4986, namely:

> ". . . . .it has become abundantly clear that rate ceilings have not been effective in shielding housing during periods of tight money. Instead they discriminate against small savers, encouraging the flow of funds to unregulated intermediaries, discourage savings and contribute to inflation."
>
> "The present structure cannot fulfill the temporary mandate given in 1966 to Regulation Q to provide an even flow of funds into housing. Regulation Q addressed only fund flows between commercial banks and thrift institutions. Market forces have made this intramural war irrelevant. Such savings alternatives such as the so-called money market funds, which are uninsured, offer the small saver a market rate of return on saving, have grown enormously, at the expense of insured financial institutions. Market innovators such as retailers have indicated their intent to market commercial paper in small saver denominations. It is thus clear that Regulation Q and its mandate of below market rates to small savers is driving money out of the financial system, out of housing, and into noninsured intermediaries. Regulation Q's original purpose, temporary as it was, has been overrun by events in the marketplace."
>
> "The committee has carefully considered the reservations against phasing out the Regulation Q ceilings advanced by some representatives of the thrift and housing industries. The committee is certainly aware of the vital role played by the thrift industry in meeting our national housing needs and the committee does not intend to undermine that role. For that reason, the committee has provided the regulators with adequate flexibility to adjust the timetable for phasing out Regulation Q should future economic conditions so warrant. In any event, the committee believes that the thrift and housing industries can no longer afford to base their future survival on the perpetuation of Regulation Q ceilings. Regulation Q has been and will continue to be bypassed by developments in the marketplace regardless of what the Congress or the regulators may do. (S. Rep. No. 96-368, 96th Cong. 1st Sess 3,4 (1979).

It is clear from the legislative history accompanying the Deregulation Act that the Congress enacted this law only after great deliberation and that Congress provided the Depository Institutions Deregulation Committee with clear instructions about the scope of their responsibility under this law. We feel, therefore, that less than three months after the law's enactment, it would be presumptuous for any trade association to tell the Congress what it really meant when it passed Title II of P.L. 96-221. The Congress knows that better than we do, and fortunately states very clearly its intentions about the purposes of interest rate decontrol; the Congress clearly encourages financial institution competition in the Conference Report accompanying the legislation.

It is our Association's position that the financial deregulation embodied in P.L. 96-221 is the answer to the housing industry's problems and to the worries of the S&Ls. Deregulation is the solution, not the problem. Thanks to deregulations, magnificent opportunities exist to create new ways of financing housing, to free the thrift industry from an outdated role, to stabilize the deposit base that supports housing and to bring new sources of funds into the housing market.

ORGANIZATION OF DIDC

On the issue of the organization of the DIDC, we believe that the Congressional decision to transfer the authority to set interest rate deposits from the Federal Reserve Board, the FDIC and the FHLBB to a six-member Depository Institutions Deregulation Committee was fair and equitable. We believe in the integrity of the individuals serving on DIDC, and it is our judgment that the Committee's constitution is without bias against the interest of commercial banks, or thrift institutions, or the housing industry. We believe that the Committee's paramount responsibility is to the American consumer, who is interested in the safety and soundness of American financial institutions and who deserves the opportunity to earn a fair return on his or her savings investment. The membership of the committee consists of:

(1) The Secretary of the Treasury, whose interests are in the health of the economy at large -- including the savings and loan industry, as well as the banking industry, the consumer, the home builder, the farmer, the auto manufacturers, and small businesses of all types;

(2) The Chairman of the Board of Governors of the Federal Reserve System, whose interests, like the Secretary of the Treasury, are far broader than just those of a particular industry. His principal concern is with monetary policy; his regulation of financial institutions forms only a small part of the implementation of that policy; and the Federal Reserve regulates, in one degree or another, non-bank financial institutions (like savings and loans), as well as the banks, on matters such as reserves and the administration of consumer protection regulation (Regulation B, Equal Credit Opportunity, Regulation Z, and Truth in Lending are regulations of the Federal Reserve which apply to savings and loans as well as commercial banks);

(3) The Chairman of the National Credit Union Administration. Any allegation that the Chairman is biased in favor of banks is patently ridiculous on its face. His interests are for the economic vitality of the credit unions he regulates; credit unions were provided with substantive new authorities under this Act with respect to transaction accounts and the maintenance of reserves, and it is, therefore, reasonable for NCUA's designation to the Committee.

(4) The Comptroller of the Currency is a non-voting member;

(5) The Chairman of the Federal Home Loan Bank Board is similar to any other designee to the Committee and is legally responsible for the supervision of the savings and loan industry, which does not infer an anti-bank bias.

(6) The Chairman of the Federal Deposit Insurance Corporation is the only voting member of the committee whose principal interests are related to the operation of commercial banks. And even he has other interests. The FDIC also regu-

lates and insures mutual savings banks which, like savings and loans are "thrift institutions."

Also keep in mind that the membership of the committee consists of federal regulators, not members of some industry trade associations. Relations between an industry -- any industry -- and its regulators are as often adversarial as they are friendly. It is a serious mistake and a disservice to claim that anyone whose job it is to regulate one segment of the financial industry is, therefore, a biased advocate of that segment.

In sum, the composition of the DIDC is just, and fair, and neutral as between competing interests. What the DIDC has done was done because it was right as far as it went, factually and legally, and in the public interest.

DIDC Actions on Premiums and Finders' Fees

Acting upon initiatives by the thrift trade associations, the Deregulation Committee got off to an inauspicious beginning at its very first meeting. The Committee proposed changes in the regulation of premiums as a means of attracting deposits and in the use of finders' fees to motivate existing customers to "find a friend" to place a deposit at the finder's depository institution. On the latter point, the DIDC proposed that the finder's fee be calculated as a part of the interest paid on the deposit the finder had generated; this proposal seems reasonable and warranted, judging from all available evidence.

The ban on the use of premiums to attract deposits is another matter altogether. In our Association's comment letter submitted to DIDC on July 16, 1980, we observed that in the light of the comptetive situation facing banks from both the money market funds and thrift institutions that "at this time, the majority of the industry opposes a complete ban on such marketing tools (i.e., the offering of premiums or gifts associated directly with the receipt of a deposit). . ." (A copy of comment letter is appended as Attachment III).

My own experience in traveling around the country talking with bankers and consumers alike is that premiums are of equal or greater importance to consumers than are increases in the rates paid on deposits. Knowing that a segment of th population is so inclined (a phenomenon well known to retailers, grocery chains, etc.), why should depository institutions be denied this marketing tool?

We appreciate the reasons why the Deregulation Committee sought comment on the premium regulations and the use of finders' fees, but we regret that these issues had to be the first ones the Committee addressed.

The May 28 DIDC Decisions

On May 28, the Deregulation Committee adopted Rule 0008. That rule has been characterized in a very inaccurate and objectionable way by elements of the specialized thrift industry, which are attempting to blame the problems of the housing industry on that rule alone.

The simple, unavoidable fact is that all the Deregulation Committee did on May 28 was to allow the rules for six-month money market certificates of deposit which had been in effect for almost a year to continue in effect -- though in a very limited, complex way. The rule represents the most tentative, smallest possible step toward eventual deregulation of deposit rate ceilings. The rule in no way causes funds to flow out of thrift institutions and into banks; in fact, the only market effect of the rule was avoidance of a massive drain of deposits from banks into thrift insitutions in the short term.

And if today's market rates of interest remain in effect six months from now, when full service banks will be approaching their second roll-overs of six-month certificates without continuing parity, serious new concerns will be raised.

A review of Rule 0008 in its entirety shows just how limited and tentative it is. On the positive side, the Deregulation Committee did deal with the then-existing serious threat of deposit drains from commercial banks if the interest rate gap had continued to apply to existing six-month money market certificates maturing at banks. On the negative side, the Deregulation Committee continued to yield to the folklore and myths of the interest rate differential in that it continued the differential on 30-month certificates and simultaneously enhanced the attractiveness of those instruments in the current environment.

Essentially, the Deregulation Committee made four changes in the regulation of money market certificates:

1. When T-bill rates are 8.75% or higher, all institutions may pay 25 basis points above the auction rate.
2. A minimum ceiling of 7.75% was established.
3. A differential favoring S & Ls and mutual savings banks will exist when the bill rate is between 7.25% and 8.75%.
4. Banks may roll over MMCs (Money Market Certificates) maturing during a 6 month period following May 29 at the ceiling rate applicable to S&Ls and mutual savings banks.

With respect to the small saver 30-month CD, the Deregulation Committee established a minimum ceiling of 9.25% for banks and 9.50% for S&Ls and mutual savings banks, and raised the schedule of interest payable by 50 basis points between the minimum and maximum ceilings.

We believe that these actions were fully justified in view of the competitive pressures facing all depository institutions. It must be recognized that the real competition to savings and loans comes not from commercial banks but from the unregulated-non-depository institutions. During the month of May, before the ceilings changes were made, MMFs gained an estimated $8.4 billion (according to Donoghue's Money Funds Report of Holliston, Massachusetts), while the Federal Reserve Board figures indicate an outflow of $7 billion for MMCs.

These figures make it absolutely clear that the competition from unregulated money market instruments is and ought to be a major concern of the DIDC. Yes, there is a real differential -- but it's not the one the S&Ls are worried about. It's the differential between the rates all regulated depositories can pay and the rates paid by money market mutual funds -- and other unregulated competitors in the market place.

The quarter percent S&L mentality is a thing of the past. Faced with the unalterable reality of money market mutual funds, which have grown from under $11 billion to over $75 billion in the past 18 months, the only answer for all of us — full service banks and S&Ls alike — is deregulation.

The May 28th decision of DIDC is proper both legally and economically. The decision of the Committee clearly conforms with the directions of the law "to provide for a phase-out of Regulation Q just as soon as is possible." (Conference Report S.R. 96-640, 96th Cong. 2d Sess. 72(1980)), and is within the flexible limits afforded by the law to the DIDC. ("The committee is not bound by any target. It may exceed the target if economic conditions warrant. . ."

Id.) (Emphasis supplied.) Most importantly, however, the rule adopted by the DIDC is in concert with the committee's obligation to see:

> ". . .that the phase-out must be accomplished in a way that ensures equity for depositors, especially those savers with small accounts, and ensures competitive equity among depository institutions and between depository and non-depository institutions that compete for the savings dollar." (Conference Report, p. 73.)

Another misconception which has been directed against Rule 0008 is that DIDC has placed a "floor" on the interest rates payable on money market certificates. This characterization is completely erroneous. It serves only to show that Reg Q ceilings have been binding for so many years that some institutions have misinterpreted the actual purpose of a ceiling. The regulators are not setting the rate institutions must pay; the are setting a maximum permitted rate. The purpose of the six-year transition period is to encourage each institution to evaluate its own situation and learn to set deposit rates based on the conditions under which it operates. The importance of this point cannot be overstated; in the free market environment into which depository institutions are moving, each institutuion must independently make its own determination of the deposit rates it will pay.

The issue that is at the center of the apparent dispute between banks and thrift institutions over the May 28th decision of DIDC is the matter of a differential on money market certificates. Certainly, our position on the question of rate differentials on any type of deposit is quite clear. We did, however, compromise on this issue by supporting P.L. 96-221, even though it mandates the continuation of the differential on those types of accounts in existence on December 10, 1975, for a six year period. We believe that the imposition of a differential on the money market certificate -- or any other newly created type of deposit -- will be counterproductive, and represents a direct contradiction to the spirit of the Depository Institutions Deregulation Act. Attached to our testimony is a letter to the Deregulation Committee citing data we collected during a survey of 140 community banks in 15 states across the country. The data strongly suggest that most banks are heavily dependent on money market certificates as a source of funds. Moreover, many of the banks that are heavily dependent on MMCs also have high loan/deposit ratios and would encounter severe liquidity problems if they experienced a runoff in their MMCs. Finally a larger number of these banks have a significant portion of their loan portfolio in loans to small business and agriculture or in residential mortgages. These borrowers would obviously be affected by a reduction in the availability of bank credit.

It is unfortunate how some members of the thrift industry have attempted to equate solution of the recent recession within the homebuilding and real estate industries with their self-protectionist arguments about market rates and the differential. It is claimed that the "market rate" is the rate for Treasury bills. On this point we note only that there was no complaint from the thrift lobbies before June of this year when the interest rate ceiling on Money Market Certificiates was 1/4% above the rate for Treasury bills in the case of savings and loans, and equal to the Treasury bill rate in the case of commercial banks, when the Treasury bill was 8-3/4% or less. In point of fact, the savings and loan industry does not object per se to paying rates "above the market rate" by their definition. They object only when commercial banks are given the same right, i.e., when the DIDC attempts to carry out its statutory obligation to ensure competitive equality among depository institutions. The thrift lobby has never leveled with the housing industry about the economic reality that the funds held by banks are fungible so far as investment in housing is concerned. Claims that a quarter per cent differential will solve the housing problem are absurd. Such claims are shot through with false assumptions. They are predicated on the notions that money in banks will not go to housing (it does, and in greater number each year) and that some special "commitment" to housing (a commitment which S&Ls and mutual savings banks have both been moving away from for years) entitles them to anticompetitive advantages. Finally, such claims belie the fact that the American saver is well aware of the investment opportunities available in the money markets outside of regulated depository institutions.

Thus, the real competition to savings and loans comes not from commercial banks able to pay no more than the savings and loans can for Money Market Certificates or Small Saver Certificates; rather, the real competition -- for both of us -- comes from the unregulated non-depository institutions, like Money Market Mutual Funds, which are able to pay a higher rate of return, and thus able to attract the savings of the public away from savings and loans -- and banks. The DIDC has taken a first step toward creating some competitive balance between depository institutions and non-depository institutions, as is its obligation under the law.

Improvement In DIDC Communications

Mr. Chairman, I must add that the Deregulation Committee's May 28 actions have underlined the serious extent of communications problems within the regulatory agencies and between the regulators and the financial community. Much of the controversy that has swirled around DIDC's May 28th decision probably could have been avoided had the Committee's decision been promulgated in a procedurally more lengthy time period. Bankers are unanimous in their belief that far too short a time period was permitted for everyone to analyze and understand the new rules before those rules took effect; as a result, serious confusion and misunderstandings developed.

It is unrealistic in the highest degree for any group to assume that its decisions can automatically be made known in all their ramifications in the space of four to six working days throughout the financial community. There were not enough telephone lines at the Federal Reserve for that agency even to inform its district and branch offices of the details of the new rules before the rules took effect -- much less for the substance of the rules to be communicated to banks and the thrift industry.

We suggest strongly that in the future the agencies provide a period of several weeks before new rules take effect so that all those who will be subject to the new rules will have a full opportunity to understand them. In the case of the May 28 decisions, the Deregulation Committee could simply have stated that the old rules providing parity on six-month certificates would remain in effect for three weeks (as though the going rate had remained above nine percent), with the new rules to take effect at the end of the three-week period.

Housing

The thrift industry has worked long and hard to convince Congress and the regulators that a strong linkage exists between their differential advantage in deposit rate ceilings and the stability of residential construction industry. The facts, however, do not support this allegation.

Experience over past interest rate cycles clearly shows that deposit rate ceilings -- especially a differential -- serve only to exacerbate the cyclical nature of the housing industry by artifically restricting the availability of mortgage credit during periods of high market interest rates. In each of the previous interest rate cycles, regulated depository institutions have experienced disintermediation in response to the divergence between deposit ceilings and market rates. Moreover, the slowdown in deposit flows at savings and loans has generally been more severe than those experienced by banks, in spite of their differential rate advantage. It appears that the differential may be responsible for attracting those deposits which are most interest sensitive, thus increasing the vulnerability of S&Ls to disintermediation during periods of high market rates. In any case, the deposit rate ceilings clearly encourage a runnoff of funds from all regulated deposit instruments into higher yielding alternative investments. Clearly, the reimposition of any rules limiting lenders' flexibility and power to innovate run contrary to the indisputable facts of the new marketplace. Regulation Q is such a rule. It helps no one, least of all homebuilders, homebuyers and the S&Ls. If depository institutions are to continue to serve as the nation's principal financial intermediaries and mortgage orginators, they must be free to compete for deposit funds in the open market.

Housing is at a low period now for many reasons, none of which has anything to do with the May 28th decision of DIDC. Housing has both benefited and been grievously harmed by inflation. Inflation has benefited housing by stimulating the purchase of a home as the best hedge against inflation, and inflation has benefited the home finance market by attracting the interest of lenders and investors other than thrift institutions and banks. Inflation, too, has harmed the housing industry by dramatically increasing the cost of buying or renting decent housing. This burden falls especially hard on young couples buying their first home, the elderly on fixed incomes, and lower-income families. Basically, what is happening in the housing market is that housing costs are accelerating faster than household income, which means that families at all income levels are paying a higher percentage of their income for housing. Nevertheless, despite higher housing costs and relatively high interest rates, we believe that the unmovable object of high mortgage rates will give way to the irresistible force of increasing demand. Congress properly recognized that a significant part of our housing finance problems were the state barriers to the free flow of mortgage funds created by outdated mortgage usury laws, which the Congress wisely preempted in P.L. 96-221. This will help our industry to invest more of our depositors' funds in housing, but the major problem confronting housing is how to keep the economy on an even keel by avoiding spiraling double-digit inflation rates, thus moderating swings in interest rates.

The involvement of commercial banking in home mortgage lending has matured over the past decade as banks have learned about the retail opportunities in residential lending and as they have become aware of the increasing options available in the secondary mortgage markets. Banks are now the second largest source of single-family mortgage loans. For the period 1977-79, outstanding mortgage volume at banks grew 50% faster than that of S&Ls. In general, over the past ten years, banks' share of the residential mortgage origination market has grown -- while S&Ls and others have let their commitment decline. And this in the face of the Reg Q differential and the fact that until 1970 national banks were effectively prevented by law from making mortgages on the same terms as other lenders. Even today, banks are discriminated against by the Federal Home Loan Mortgage Corporation which charges banks a 1/2% higher sales fee than federal S&Ls must pay for the delivery of mortgages to that secondary market facility.

Attached to this testimony is a statistical summary of the banking industry's investment in housing, real estate and community development activities. We conservatively estimate that banks have committed some $346.5 billion to these sectors of the economy.

The direct home mortgage origination is only one part of a very complex structure that provides money for homebuying. Traditional theories of crisis-management at times when the housing market is depressed have focused only on the one point of direct mortgage origination. Other points must be considered also, and it may be that such other areas will supply the key to unlocking new kinds of home mortgage credit. Pass-though certificates, developed by commercial banks, make it possible for pension funds and investment banking firms to invest in housing. And commercial banks have already contributed much to the growth of the secondary mortgage market.

Another new idea could be to develop the secondary mortgage market further, and to create a widely available mortgaged backed investment instrument that yields a market rate. This could be used to attract funds into housing from still untapped new sources, including pension systems. The stark fact is that banks and S&Ls cannot provide all the funds needed to finance housing. Pension funds and other big investors must be brought into housing finance -- but that cannot happen until the processes of deregulation and innovation make mortgage-backed securities sufficiently attractive.

As the Secretary of the Treasury observed in his testimony of June 21, 1979, before the Senate's Subcommittee on Financial Institutions, conditions in the housing credit markets today are vastly different from what they were in 1966, when the Interest Rate Control Act [P.L. 89-597] was enacted as a temporary measure to prevent interest rate competition among depository institutions.

Since the mid-1960's, federal housing policies have worked well in providing the housing credit market with alternative sources of credit, making housing less sensitive to changes in the flows of funds to thrift institutions. The public sector has become a significant supplier, directly as well as indirectly, of mortgage credit.

The direct intervention of the public sector has principally been through the secondary mortgage market, where both the Federal National Mortgage Asociation and the Federal Home Loan Mortgage Corporation have supplied mortgage credit in a significant volume since 1970.

In 1965, FNMA holding of home mortgages amounted to $2.5 billion; by 1978 these holding amounted to $37.6 billion. FHLMC holdings of home mortgages increased from about $400 million in 1970 to $2.5 billion in 1978. Total federal agency holdings of home mortgages (including the holdng on on-budget agencies such as the Government National Mortgage Association, the Farmers Home Administration, the Federal Housing and Veterans Administrations, and Federal Land Banks) increased from $6.4 billion in 1965 to $35.5 billion in 1976, or by about 455 percent in little over a decade. The rate of growth in these mortgage holdings was most pronounced in the periods of disintermediation. Currently, preliminary data show that total federal agency holdings of home mortgages as of the final quarter of 1978 amounted to about $44 billion.

The public sector has also become a significant indirect supplier of mortgage credit over the last decade or so. This has taken place largely through Federal Home Loan Bank advances to savings and loan associations and the rapidly expanding use of federally-guaranteed securites for the prupose of financing home mortgage pools. The advances of the Federal Home Loan Banks to savings and loan associations have increased sharply in periods of disintermediation. Thus net advances peaked at $5.5 billion in 1966, $9.0 billion in 1970, and 19.2 billion in 1974. Thus far in 1979, advances outstanding have reached $32 billion.

Over the same period, mortgage pools, for which the interest and principal payments are guaranteed by GNMA, also grew notably -- from about $100 million in 1965 to about $66.7 billion at the end of 1978, of which $53.3 billion was held outside of savings and loan associations.

Another factor of difference between the housing market of 1966 and 1979 is that as the largest private capital market in the U.S., this market has become attractive to a variety of other lenders besides the thrift institutions. The

best copy available

recent dramatic rise of pass-through type securities, mortgage-backed bonds and even municipal-bond financing of home mortgage loans through a type of industrial development authority confirms the interest of other lenders in capturing a share of this credit market. Thus, while savings and loan associations hold the largest portion of mortgage debt, with 47% of all 1-4 family mortgage debt, other lenders are actively entering the home mortgage market without the benefit of any interest rate differential, and it can be expected that commercial banks and pension funds will increase their shares of the housing finance market.

Most observers of the residential finance industry who are familiar with the pioneering efforts of commercial banks and investment bankers in the secondary mortgage markets believe that the role of commercial banks will continue to expand in future years. One reason for this is the fact that in P.L. 96-221, the thrift institutions were given in Titles II, III and IV of the Act additional new powers to compete with banks on equal terms in the retail banking area. We believe that this will have an equilibrium effect on the housing finance business because, as some thrift institutions will reduce their specialization in residential mortgage lending, this will provide a new market opportunity for banks.

Finally, Mr. Chairman, we feel that the role of commercial banks through ownership of mortgage banking firms in mortgage is often overlooked, but yet a source of major financial investment by the banking community to the housing and real estate industry. Mortgage banking, in general, appears to be a growth industry, reflecting investors' growing acceptance of private mortgage insurance and mortgage bonds. Commercial banks (and bank-affiliated mortgage companies) because of their generally larger capital, we believe, are better able to take market risks, and important factor in an environment of unstable interest rates.

S. 2927

In light of the above assessment of the futility of deposit rate ceilings and the differential, our Association strongly opposes S. 2927. We feel that it is counter-productive to reduce the flexibility of the DIDC to phase-out Reg Q ceilings. As we pointed out in the early part of our testimony, the DIDC is charged with the dismantling of the elaborate structure of interest rate celings as quickly and as equitably as possible. Surely it would be a step backwards to begin weakening the ability of the DIDC to create a more competitive and balanced financial environment a scant five months following the committee's creation.

CONCLUSION

In summary, all financial institutions are in an important time of transition with regard to our marketplace. Trying to slow or stop the evolution of a free market is a step backward.

The answer to the housing finance problem is deregulation. Deregulation will permit banks to continue to increase their roles as housing lenders while permitting thrifts to diversify their services. Deregulation will allow new sources of funds to be tapped for housing needs. Deregulation will allow all depository institutions to pay market rates to savers, thus assuring a healthy, stable base for housing and other credit needs. Deregulation also will help all traditional depository institutions to compete with money market mutual funds, which are moving assets away from communities and local housing credit needs at a rate of over a billion dollars a month. Deregulation offers fresh solutions to old problems, and will move housing away from boom and bust cycles brought on by artificial stimulents and artificial controls.

Thank you for listening to our views. We look forward to the opportunity to answer any questions you might have.

* * *

ATTACHMENT I

AMERICAN
BANKERS
ASSOCIATION

1120 Connecticut Avenue N.W.
Washington D.C.
20036

EXECUTIVE VICE PRESIDENT

Willis W. Alexander
202/467-4211

y 13, 1980

e Honorable G. William Miller
cretary of the Treasury
shington, DC 20220

The Honorable Irvine H. Sprague
Chairman, Federal Deposit Insurance
Corporation
550 Seventeenth Street, NW
Washington, DC 20249

e Honorable Paul A. Volcker
airman, Board of Governors of
the Federal Reserve System
shington, DC 20551

The Honorable Jay Janis
Chairman, Federal Home Loan Bank
Board
1700 G Street, NW
Washington, DC 20552

e Honorable John G. Heimann
mptroller of the Currency
90 L'Enfant Plaza, SW
ashington, DC 20219

The Honorable Lawrence Connell
Chairman, National Credit Union
Administration
Washington, DC 20554

entlemen:

n a letter last week, I urged you and the other members of the Depository nstitutions Deregulation Committee to take immediate action to eliminate he interest rate differential on money market certificates of deposit at ll interest rate levels. Failure of the Committee to act by this Thursday ould result in the reimposition of the differential between commercial banks nd other depository institutions. Such a reimposition would, we feel, eriously impair the ability of banks to make small business, agricultural nd residential mortgage loans, because a significant portion of the commercial banks' time and savings base is made up of certificates which might oon be subjected to a differential. This problem appears to be most acute or those banks with assets under $100 million.

n May 7 and 8 we gathered current financial data from 140 commercial banks n 15 states from across the country. Of the 140 banks in the sample, 110 ere under $100 million in total assets. The data compiled from each bank ncluded money market certificates, total time and savings, small business nd agricultural loans, home mortgage loans, total loans, and total deposits. he states sampled included: Arkansas, California, Colorado, Indiana, Iowa, ichigan, Minnesota, New York, Ohio, Oklahoma, Oregon, Tennessee, Texas, irginia, and Wisconsin.

The preliminary results are presented in the attached tables, but I would like to summarize the most significant findings. 1) Money market certificates at 140 banks in the sample averaged 32% of time and savings deposits. 2) The loan deposit ratios averaged 69%. 3) Loans to agriculture and small business averaged 31% of total loans. 4) Residential mortgage loans averaged 26% of total loans. 5) 26% of the 140 banks in the sample had money market certificates exceeding 40% of their time and savings deposits.

One should, of course, be cautious about drawing generalizations from data on this limited sample of banks. Nevertheless, this is the only available information showing the current condition of a representative number of banks. These most recent data suggest that most banks, particularly banks under $100 million, are heavily dependent on money market certificates as a source of funds. Moreover, many of the banks that are heavily dependent on money market certificates also have high loan deposit ratios and would encounter severe liquidity problems if they experienced a runoff in their money market certificates. Finally, a large number of these banks have a significant portion of their loan portfolio in loans to small business and agriculture or in residential mortgages. Such borrowers would obviously be affected by any reduction in loans at these banks.

The result of reestablishing the differential for these now rate sensitive funds will certainly be in disintermediation from these banks with predictable impairment of their ability to serve agricultural, small business and residential mortgage needs. Therefore, we urge the Committee to take immediate action to eliminate entirely the differential on money market certificates.

Sincerely,

Willis W. Alexander

encls.

Table 1
Average of Balance Sheet Ratios
for 140 Banks
Survey of May 7-8

ate	# Banks	MHCs as a percent of time and savings deposits	Loan-Deposit ratio	Agricultural and small business loans as a percentage of total loans	Home mortgage loans as a percentage of total loans
	%	%	%	%	%
rkansas	9	38	60	28	20
alifornia	10	25	74	24	15
olorado	7	26	73	27	20
ndiana	10	39	66	29	36
owa	7	32	70	30	24
ichigan	7	31	70	36	31
nnesota	17	36	74	45	28
ew York	9	24	60	16	32
Ohio	10	30	63	20	33
Oklahoma	9	34	69	42	11
Oregon	10	32	72	34	18
Tennessee	10	41	68	27	26
Texas	8	37	62	50	6
Virginia	6	34	73	8	36
Wisconsin	11	23	71	30	39
Average for Banks Surveyed	140	32	69	31	26

Table 2
Summary of Phone Survey on May 7-8

State	Number of banks responding	Number of banks with under $100 M in deposits	Number of banks with over 40% of time and savings deposits in MMCs
Arkansas	9	7	5
California	10	9	0
Colorado	7	6	2
Indiana	10	8	4
Iowa	7	5	1
Michigan	7	5	2
Minnesota	17	15	5
New York	9	8	2
Ohio	10	8	0
Oklahoma	9	7	4
Oregon	10	8	1
Tennessee	10	8	4
Texas	8	6	5
Virginia	6	2	2
Wisconsin	11	8	0
Total	140	110	37

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·AMERICAN BANKERS ASSOCIATION · COMMUNICATIONS GROU · 1120 CONNECTICUT AVENUE NW · WASHINGTON DC 2003

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FOR IMMEDIATE RELEASE
(BJ)

ABA ASKS REGULATORS TO END DIFFERENTIAL ON POPULAR CERTIFICATES

WASHINGTON, D.C., May 13 -- The American Bankers Association (ABA) today renewed its urgent call to federal regulators to eliminate immediately the interest rate differential on money market certificates of deposit at all interest rate levels.

The Association said a May 7-8 telephone survey of 140 full service banks shows that reimposition of the quarter per cent interest rate disadvantage on commercial banks would cause many banks to have to reduce their lending, particularly to farm, small business and home mortgage borrowers.

In a letter to the Depository Institutions Deregulation Committee, ABA Executive Vice President Willis W. Alexander said today that a reimposition of the interest rate differential would seriously impair the ability of banks to make small business, agricultural and home mortgage loans, because a significant portion of the commercial banks' time and savings base is made up of certificates which will be subjected to a differential if the Committee fails to act.

ABA last week petitioned the Deregulation Committee to end the differential on money market CDs. Today's letter renewed that call and added new information for the regulatory agencies to consider.

The maximum rate payable on the certificates fluctuates with the rate on six-month Treasury bills. Above the nine per cent level, all financial institutions have an equal rate ceiling on the certificates. Below the nine per cent level, the differential is reimposed -- a differential of up to one-quarter per cent.

On May 12, the rate for six-month Treasury bills fell to 8.78 per cent;

(more)

effective May 15, the differential therefore could be reimposed on the money market certificates. The maximum for thrift institutions would be 9 per cent; and the maximum for banks would be 8.78 per cent.

ABA's telephone survey covered 140 banks in 15 states; 110 of the banks are under $100 million in total assets.

The survey, Alexander said, suggests that most banks, particularly banks under $100 million, are heavily dependent on money market certificates as a source of funds. Money market certificates average 32 per cent of total time and savings deposits at the 140 banks surveyed.

Moreover, "many of the banks that are heavily dependent on money market certificates also have high loan-deposit ratios and would have severe liquidity problems if they experienced a runoff in their money market certificates," Alexander asserted.

The 140 banks have an average loan-deposit ratio of 69 per cent, with farm and small business loans averaging 31 per cent of the total, and home mortgages accounting for 26 per cent of the total.

"The result of reestablishing the differential for these now rate-sensitive funds will certainly be disintermediation from these banks with predictable impairment of their ability to serve agricultural, small business and residential mortgage needs," Alexander warned.

ABA is the national trade association for full service banks. Its membership comprises over 90 per cent of the nation's banks, including more small banks than any other trade association.

# # #

ATTACHMENT II

BANKING'S INVESTMENT IN HOUSING FINANCE

The home mortgage market represents the largest private capital market in the U.S., with over $150 billion in home mortgages originated annually by all lenders. Only the debt requirements of the Federal government exceed the annual credit requirements for home mortgages.

In order to raise the enormous capital required for mortgage lending, a complex network of lenders, government agencies, and investors has been developed to deliver mortgage loans to the millions of families and individuals buying a home each year. The two largest sources of mortgage credit funds are savings and loan associations (of which there are about 4,400 institutions) and commercial banks (of which there are about 14,500 institutions). Other lenders are the mutual savings banks (500 institutions); mortgage bankers; and life insurance companies.

In the past, thrift institutions have garnered most of the credit for financing residential housing. But direct mortgage credit is not the sole requirement for providing decent housing. Housing also depends on the existence of streets and sewers, utilities, construction companies and industry to produce housing materials; each of these elements is financed by banks.

I. Residential Mortgage Loans

Banks held $158.7 billion in residential mortgages at the end of the fourth quarter of 1979, ranking second only to the savings and loan industry in these loans. Moreover, commercial banks originated $10.8 billion in residential mortgage loans during the fourth quarter of 1979.[1]

Residential Mortgage Loans Outstanding by Type of Lender
Fourth Quarter 1979

(Billions of Dollars)

Lender	One-to-Four Family	Multi-Family	Total
Savings & Loan Associations	394.4	37.6	432.0
Commercial Banks	146.1	12.6	158.7
Mortgage Pools or Trusts	101.6	7.1	108.7
Mutual Savings Banks	64.7	17.2	81.9
Federal & Related Agencies	52.9	13.7	66.6
Life Insurance Companies	16.2	19.3	35.5
All Others	96.0	23.4	119.4
TOTAL	871.9	130.9	1002.8

Source: Federal Reserve Bulletin, April, 1980.

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[1] HUD News No. 79-264, August 16, 1979.

II. Secondary Mortgage Market

The secondary mortgage market has become an increasingly vital segment of the total residential financing scheme. Banks contribute significantly to the support of these secondary markets through ownership of their securities. As of the end of the first quarter of 1980, banks held $12.1 billion in debt securities of the three government sponsored secondary market agencies. Banks hold almost 18% of the total outstanding debt issues of the largest of the agencies, the Federal National Mortgage Association.

In addition to these secondary mortgage market securities, banks also hold $ 8.6 billion in securities of the Federal Home Loan Banks, and $ .7 billion in Farmers Home Administration notes. Thus banks hold a total of $21.4 billion in obligations of federal government agencies involved in housing.

Housing Related Securities Held by Banks

March 31, 1980

(Billions of Dollars)

Secondary Mortgage Market	
Federal National Mortgage Association	11.0
Government National Mortgage Association	.5
Federal Home Loan Mortgage Association	.6
Subtotal	12.1
Other housing related Agencies	
Federal Home Loan Banks	8.6
Farmers Home Administration	.7
Subtotal	9.3
Total	21.4

Source: Treasury Bulletin, May, 1980, TSO-5.

III. Mobile Home Loans

Banks are the major source of credit for purchasing mobile homes which have become the dominant factor in the low-cost housing market. Mobile homes accounted for 16.1% of the new single family dwellings sold in the U. S. in 1978[1] and strong sales continue. Mobile homes are virtually the only kind of low-cost housing that is widely available to American families earning under $8,000 per year. As of December 31, 1979, banks had $10.0 billion in mobile home loans outstanding.[2]

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[1] Savings and Loan Fact Book, 1979.

[2] Federal Reserve Bulletin, April, 1980.

IV. Residential Construction Loans

Banks are a major supplier of funds for residential construction, an essential base of housing finance. As of the fourth quarter of 1979, banks held $15.1 billion in residential construction loans, over 37% of the total.

Holdings of Residential Construction Loans by Type of Lender
First Quarter 1979

(Billions of Dollars)

Lender	One-to-Four Family	Multi-Family	Total
Savings & Loan Associations	14.9	3.2	18.1
Commercial Banks	10.7	4.4	15.1
Mortgage Companies	1.6	.9	2.5
Mutual Savings Banks	.6	.8	1.4
Real Estate Investment Trusts	.2	.5	.7
All Others	.1	2.4	2.5
TOTAL	28.1	12.2	40.3

Source: HUD News No. 80-97, March 20, 1980.

V. Loans for the Infrastructure of Housing

The total shelter needs of families require more than just the direct financing of construction and final mortgages. Also needed are services to make a house usable — for example, such private and municipal services as electricity, water, streets and sewers. Considering all financing requirements to provide adequate housing and related facilities, banks rank near the top of the lending groups. Some of the most recent data available reveal that banks:

Provide $8.5 billion in home improvement loans.1/

Provide credit assistance to the housing industry indirectly through the loans they make to other housing lenders, such as savings and loan associations, mortgage bankers, life insurance companies and real estate investment trusts, totaling an estimated $26.4 billion.1/

1/ Federal Reserve Bulletin, August, 1979.

As of December 1979, banks held $135.9 billion in municipal securities, over 46% of the total.1/ An estimated $106.4 billion or 78.3% of total bank holdings were issued to finance residential support facilities - schools, roads, utilities and hospitals. This estimate is based on the percentage of 1979 proceeds from new security issues of state and local governments used for such purposes.

Use of Proceeds of
New Security Issues
Of State and Local Governments
1979

Use of Proceeds	Billions of Dollars	Pct. of Total
Public Housing, Hospitals and other Health Institutions	$15.5	37.3%
Utilities and Conservation Water, Sewer, Electric & Gas and Pollution Control	8.5	20.5
Education Elementary, Secondary, Colleges & Universities	5.1	12.3
Transportation Roads, Bridges, Ports & Airports	2.4	5.8
Parks and other Recreational Facilities	.5	1.2
Fire Stations, Police Stations and other Public Safety and Service Facilities	.5	1.2
Industrial Aid	3.8	9.2
Other Purposes	5.0	12.0
TOTAL	41.5	100.0%

Source: Municipal Market Developments, Public Securities Association, March, 1980.

Note: Components may not add to totals due to rounding.

1/ Flow of Funds Accounts - Financial Assets and Liabilities, Federal Reserve Board, December 31, 1979.

VI. Measuring the Banking Industry's Contribution to Housing

Residential Mortgage Loans	$158.7
Mobile Home Loans	10.0
Residential Construction Loans	15.1
Federal Housing Agencies Obligations	21.4
Home Improvement Loans	8.5
Loans to Other Housing Lenders	26.4
Municipal Securities Supporting Housing	106.4
TOTAL	$346.5

The $346.5 billion commitment by the banking industry to housing is a rough estimate, but a conservative one. It does not cover an indeterminate amount of loans to contractors, building suppliers and other businesses engaged in housing construction, servicing, and supply. But by any standard of measurement, a $346.5 billion investment is a very significant commitment to the housing industry. This puts banks in a close second position to the savings and loan associations in the overall financing of the nation's housing needs.

ATTACHMENT III

AMERICAN
BANKERS
ASSOCIATION

1120 Connecticut Avenue, N
Washington, D.C.
20036

EXECUTIVE DIRECTOR
GOVERNMENT RELATIONS

Gerald M. Lowrie
202/467-4097

July 16, 1980

Normand R.V. Bernard
Executive Secretary
Depository Institutions Deregulation
  Committee
Federal Reserve Building
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Mr. Bernard:

The American Bankers Association wishes to express its views concerning the Depository Institutions Deregulation Committee's proposal to prohibit the offering of premiums or gifts associated directly with the receipt of a deposit. In addition, finders fees to third parties would be regarded as the payment of interest to the depositor and such remuneration would be required to be paid in cash. Finally, the Committee requests comments to an intended requirement that all interest earned on a deposit be paid in the form of cash or a credit to a deposit account. This would eliminate programs, currently authorized under Federal Reserve, FDIC, and FHLBB regulations, in which interest can be prepaid in the form of merchandise.

Current regulations regarding permissible bank premium offerings [12 C.F.R. 217.147; 39 Fed. Reg. 34331 (1974)] enumerate a three-pronged analysis to adjudge the propriety of these marketing programs. First, any such gift must be offered only at the time of opening a new account or an addition to an existing account. Next, the gratuity must not occur on a continual basis. Thirdly, the value of the merchandise (excluding any shipping or handling charges) must not exceed $5.00 except where the deposit amount is greater than $5,000 when a maximum $10.00 premium is allowed.

In an effort to reflect the concerns of our membership, our Association sought widespread response to this regulatory initiative. This membership, which includes over 13,100 full service banks, represents a diverse constituency from every sector of our nation's financial community. A segment of our membership perceives widespread giveaway campaigns as an unrelated activity to the business of banking and, as a result, supports the Committee's proposal. At the same time, the majority of the industry opposes a complete ban on such marketing tools in light of the present state of our nation's commercial banks. Faced with the unalterable reality of money market funds, which have expanded from under $11 billion to over $75 billion in the past 18 months, the only answer for the entire financial industry is deregulation. The thrift industry's fallacious claims for retention of the interest rate differential merely prolongs the persistent economic maladies that afflict the financial community. We, therefore, urge swift action to remove those structural barriers which prohibit movement toward a market-oriented industry. During this period of transition to a competitive environment, our Association opposes further restrictions which inhibit banking stability and development.

Indeed, merchandise promotions and other marketing measures represent necessary alternative incentives to survive under present-day market conditions. Unduly restrictive limitations upon interest or dividend payments made on time and savings deposits place all regulated depository institutions at a critical disadvantage in attracting and retaining local deposits. Alternative bank-like providers, unfettered by the panoply regulatory constraints, have reaped substantial gains at the expense of community-oriented commercial banks.

We concur with the Committee's judgment that the present $5/$10 limitations with convoluted per item computation methods provide an unrealistic supervisory standard. We recommend a modification of the current maximum ceilings to reflect the inflationary impact of the past decade. To alleviate ambiguous disparity of merchandise pricing, the inclusion of all related costs is appropriate. These alterations should diminish various difficulties encountered by examiners.

The Committee also proposes the inclusion of any third party payments into the depositor's interest calculation when these fees are made in connection with a deposit. We cannot support this proposal. While market interest rates remain above Regulation Q limitations, bank deposits continue to flow to other institutions that carry higher rates or bank-like investments unencumbered by any regulatory restrictions. Finders fees, to a limited degree, provide a means for banks to develop and service community financial requirements.

In summary, while a segment of our membership prefers a banking industry independent of merchandise-related incentives, great unanimity urges more strident efforts to remove interest rate disparity and existent structural inequities. Fair competition promotes the efficient allocation of resources, advancement of innovative financial services, and sound management--all benefits to the consumer. It is our firm belief that the elimination of discriminatory restrictions best furnishes an environment for economic growth, development, and stability. For the reasons stated above, we oppose the Committee's proposed ban on all premium offerings by depository institutions.

Our Association appreciates the opportunity the Committee has provided to comment on this issue.

Sincerely,

Gerald M. Lowrie

Gerald M. Lowrie

STATEMENT

OF

RICHARD A. ROSENTHAL

on behalf of

THE AMERICAN BANKERS ASSOCIATION

before the

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS,
SUPERVISION, REGULATIONS AND INSURANCE

of the

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

U.S HOUSE of REPRESENTATIVES

Mr. Chairman and Members of the Subcommittee:

I am Richard A. Rosenthal, Chairman of the Board of the St. Joseph Bank and Trust Company in South Bend, Indiana, and a member of ABA's "Banking Advisors." Today, I am accompanied by J. Terrence Murray, President of Industrial National Bank of Rhode Island, who is a member of ABA's Executive Committee of the Housing and Real Estate Finance Division. Also accompanying me is Richard S. Peterson, Senior Vice President and Economist of Continental Illinois National Bank and Trust Company and a member of ABA's Economic Advisory Committee. We appreciate this opportunity to present the views of the American Bankers Association, the major banking trade association whose membership includes more than 90% of the over 14,000 full service banks in this nation.

These hearings are being held to discuss the actions taken by the Depository Institutions Deregulation Committee, created pursuant to P.L. 96-221. The Deregulation Committee (popularly known as DIDC) is charged with the difficult task of unraveling the complex structure of deposit interest rate ceilings. As this Subcommittee is well aware, the legislative decision on how to reform our financial institutions was a process involving the deliberations of the last three Congresses and included the support and policy recommendations of the past three Administrations.

Rationale for Deregulation

The product of your work, P.L. 96-221, is a consensus between many points of view and, as such, is a compromise. Our Association, for example, would have preferred to have had an immediate termination of the interest rate differential, which discriminates against bank customers, along with the phase-out of the Interest Rate Control Act over a more accelerated period than the Act's 6-year term. But, we supported, as did the trade associations of the thrift industry, the enactment of the Deregulation legislation for most of the reasons cited in the

Senate Report accompany H.R. 4986, namely:

> ". . . . . it has become abundantly clear that rate ceilings have not been effective in shielding housing during periods of tight money. Instead they discriminate against small savers, encouraging the flow of funds to unregulated intermediaries, discourage savings and contribute to inflation."

> "The present structure cannot fulfill the temporary mandate given in 1966 to Regulation Q to provide an even flow of funds into housing. Regulation Q addressed only fund flows between commercial banks and thrift institutions. Market forces have made this intramural war irrelevant. Such savings alternatives such as the so-called money market funds, which are uninsured, offer the small saver a market rate of return on saving, have grown enormously, at the expense of insured financial institutions. Market innovators such as retailers have indicated their intent to market commercial paper in small saver denominations. It is thus clear that Regulation Q and its mandate of below market rates to small savers is driving money out of the financial system, out of housing, and into noninsured intermediaries. Regulation Q's original purpose, temporary as it was, has been overrun by events in the marketplace."

> "The committee has carefully considered the reservations against phasing out the Regulation Q ceilings advanced by some representatives of the thrift and housing industries. The committee is certainly aware of the vital role played by the thrift industry in meeting our national housing needs and the committee does not intend to undermine that role. For that reason, the committee has provided the regulators with adequate flexibility to adjust the timetable for phasing out Regulation Q should future economic conditions so warrant. In any event, the committee believes that the thrift and housing industries can no longer afford to base their future survival on the perpetuation of Regulation Q ceilings. Regulation Q has been and will continue to be bypassed by developments in the marketplace regardless of what the Congress or the regulators may do. (S. Rep. No. 96-368, 96th Cong. 1st Sess 3,4 (1979)).

It is clear from the legislative history accompanying the Decontrol Act that the Congress enacted this law with great deliberateness and that Congress provided the Depository Institutions Deregulation Committee with rather clear instructions about the scope of their responsibility under this law. We feel, therefore, that less than 3 months after the law's enactment, it is presumptive for our Association or any other to tell the Congress what it really meant when it passed Title II of P.L. 96-221. The Congress knows that better than we do, and fortunately states very clearly its intentions about the purposes for interest rate decontrol and encouragement for financial institution competition in the Conference Report accompanying the legislation.

It is our Association's position that the financial deregulation embodied in P.L. 96-221 is the answer to the housing industry's problems and to the worries of the S & Ls. Deregulation is the solution, not the problem. Thanks to deregulation, magnificent opportunities exist to create new ways of financing housing, to free the thrift industry from an outdated role, to stabilize the deposit base that supports housing and to bring new sources of funds into the housing market.

The Subcommittee has indicated its reasons for these hearings are its concern that "there have been a number of complaints, ranging from procedural to substantive policy issues, during the early phases of the Committee's work. . .," and it was suggested that you would like our testimony to focus on three areas: (1) the Depository Institutions Deregulation Committee's proposed regulations placing restrictions on the offering of premiums; (2) the Depository Institutions Deregulation Committee's action on new interest rate ceilings and rate differentials on the 6-month money market CD's and the 30-month small savers CD's; and (3) the impact, if any, of the Deregulation Committee decision on the housing industry. We will be pleased to discuss each of these issues.

With respect to the Subcommittee's general concern about complaints with the organization and activity of DIDC, we would note that a legal complaint about this matter has been filed by the U.S. League of Savings Associations against the Depository Institutions Deregulation Committee in the U.S. District Court for the District of Columbia and that the members of the Committee have been named as defendants. It is unseemly, we believe, for parties of interest to a lawsuit challenging the legality of a law and the propriety of an administrative decision to have such little faith in the legal merit of its case, that it must importune the Congress of the United States while this suit is pending.

ORGANIZATION OF DIDC

On the issue of organization of DIDC, we believe that the Congressional decision to transfer the authority to set interest rate deposits from the Federal Reserve Board, the FDIC and the FHLBB to a six-member Depository Institutions Deregulation Committee was a fair and equitable decision by the Congress. We believe in the integrity of the individuals serving on DIDC, and it is our judgment that the Committee's constitution is without bias against the interests of commercial banks, or thrift institutions, or the housing industry. We believe that the Committee's only paramount responsibility is to the American consumer who is interested in the safety and soundness of American financial institutions and who deserves the opportunity to earn a fair return on his or her savings investment. The membership of the committee consists of:

(1) The Secretary of the Treasury, whose interests are in the health of the economy at large -- including the savings and loan industry, as well as the banking industry, the consumer, the home builders, the farmer, the auto manufacturers, and small businesses of all types;

(2) The Chairman of the Board of Governors of the Federal Reserve System, whose interests, like the Secretary of the Treasury, are far broader than just those of a particular industry. His principal concern is with monetary policy; his regulation of financial institutions forms only a small part of the implementation of that policy; and the Federal Reserve regulates, in one degree or another, non-bank financial institutions (like savings and loans), as well as the banks, on matters such as reserves and the administration of consumer protection regulation (Regulation B, Equal Credit Opportunity, Regulation Z, and Truth in Lending are regulations of the Federal Reserve which apply to savings

nd loans as well as commercial banks);

(3) The Chairman of the National Credit Union Administration. Any allege-
ion that the Chairman is biased in favor of banks is patently ridiculous on
ts face. His interests are for the economic vitality of the credit unions he
egulates; credit unions were provided with substantive new authorities under
his Act with respect to transaction accounts and the maintenance of reserves,
nd it is, therefore, reasonable for NCUA's designation to the Committee.

(4) The Comptroller of the Currency is a non-voting member;

(5) The Chairman of the Federal Home Loan Bank Board is similar to any
ther designee to the Committee and is legally responsible for the supervision
f the savings and loan industry, which does not infer an anti-bank bias.

(6) The Chairman of the Federal Deposit Insurance Corporation is the only
oting member of the committee whose principal interests are related to the opera-
ion of commercial banks. And even he has other interests. The FDIC also regu-
ates and insures mutual savings banks which, like savings and loans, are "thrift
nstitutions."

Also keep in mind that the membership of the committee consists of federal
egulators, not members of some industry trade associations. Relations between
n industry -- any industry -- and its regulators is as often an adversarial one
s it is a friendly one. It is a serious mistake to claim that anyone whose
ob it is to regulate one segment of the financial industry is, therefore, a
iased advocate of that segment.

In sum, the composition of the DIDC is just, and fair, and neutral as
etween competing interests. What the DIDC has done was done because it was
ight as far as it went, factually and legally, and in the public interest.

DIDC Actions on Premiums and Finders' Fees

Acting upon initiatives by the thrift trade associations, the Deregulation Committee got off to an inauspicious beginning at its very first meeting. The Committee proposed changes in the regulation of premiums as a means of attracting deposits and in the use of finders' fees to motivate existing customers to "find a friend" to place a deposit at the finder's depository institution. On the latter point, the DIDC proposed that the finder's fee be calculated as a part of the interest paid on the deposit the finder had generated; this proposal seems reasonable and warranted, judging from all available evidence.

The ban on the use of premiums to attract deposits is another matter altogether. While the ABA has not yet commented formally on this proposal, the various banker groups within the ABA structure such as the Marketing Division and the Administrative Committee of our Government Relations Council are decidedly negative toward the proposal. My experience as one of the ABA Banking Advisors who travel around the country answering consumers' questions about banking during talk shows and interviews strengthens my own conviction that premiums are a motivating factor for many depositors. In some cases, premiums are of equal or greater importance to consumers than are increases in the rates paid on deposits. Knowing that a segment of the population is so inclined (a phenomenon well known to retailers, grocery chains, etc.), why should depository institutions be denied this marketing tool?

We appreciate the reasons why the Deregulation Committee is seeking comment on the premium regulations and the use of finders' fees, but we regret that these issues had to be the first ones the Committee addressed.

The May 28 DIDC Decisions

On May 28, the Deregulation Committee adopted Rule 0008. That rule has been characterized in a very inaccurate and objectionable way by elements of the specialized thrift industry, which is attempting to blame the problems of the housing industry on that rule alone.

The simple, unavoidable fact is that all the Deregulation Committee did on May 28 was to allow the rules for six-month money market certificates of deposit which had been in effect for almost a year to continue in effect -- though in a very limited, complex way. The rule represents the most tentative, smallest possible step toward eventual deregulation of deposit rate ceilings. The rule in no way causes funds to flow out of thrift institutions and into banks; in fact, the only market effect of the rule was avoidance of a massive drain of deposits from banks into thrift institutions in the short term.

And if today's market rates of interest remain in effect six months from now, when full service banks will be approaching their second roll-overs of six-month certificates without continuing parity, serious new concerns will be raised.

A review of Rule 0008 in its entirety shows just how limited and tentative it is. On the positive side, the Deregulation Committee did deal with the then-existing serious threat of deposit drains from commercial banks if the interest rate gap had continued to apply to existing six-month money market certificates maturing at banks. On the negative side, the Deregulation Committee continued to yield to the folklore and myths of the interest rate differential in that it continued the differential on 30-month certificates and simultaneously enhanced the attractiveness of those instruments in the current environment.

Essentially, the Deregulation Committee made four changes in the regulation of money market certificates:

1. When T-bill rates are 8.75% or higher, all institutions may pay 25 basis points above the auction rate.
2. A minimum ceiling of 7.75% was established.
3. A differential favoring S & Ls and mutual savings banks will exist when the bill rate is between 7.25% and 8.75%.

4. Banks may roll over MMCs (Money Market Certificates) maturing during a 6 month period following May 29 at the ceiling rate applicable to S&Ls and mutual savings banks.

With respect to the small saver 30 month CD, the Deregulation Committee established a minimum ceiling of 9.25% for banks and 9.50% for S & Ls and mutual savings banks, and raised the schedule of interest payable by 50 basis points between the minimum and maximum ceilings.

We believe that these actions were fully justified in view of the competitive pressures facing all depository institutions. It must be recognized that the real competition to savings and loans comes not from commercial banks but from the unregulated-non-depository institutions like Money Market Mutual Funds (MMFs). For example, the annualized average rate of return over the past 30 days for the largest money market fund (Merrill Lynch Ready Assets Trust) was 9% as of as of June 27, vis-a-vis 7.73% on the MMC. If the Deregulation Committee had not established a minimum ceiling, the effective rates on the MMCs as of June 27 would have been only 7.108% for banks and 7.358% for thrifts. This would obviously place all depository institutions at a crippling rate disadvantage vis-a-vis MMFs. The effects of a severe rate disadvantage are evident in the May flow of funds. During the month of May, before the ceiling changes were made, MMFs gained an estimated $8.4 billion (according to Donoghue's Money Funds Report of Holliston, Massachusetts), while the Federal Reserve Board figures indicate an outflow of $7 billion for MMCs.

These figures make it absolutely clear that the competition from unregulated money market instruments is and ought to be a major concern of DIDC. Yes, there is a real differential — but it's not the one the S & Ls are worried about. It's the differential between the rates all regulated depositories can pay and the rates paid by money market mutual funds — a differential of roughly one-and-a-quarter percent today. And that differential was even wider in the recent past.

The quarter percent S & L mentality is a thing of the past. Faced with the unalterable reality of money market mutual funds, which have grown from under $11 billion to over $75 billion in the past 18 months, the only answer for all of us -- full service banks and S & Ls alike -- is deregulation.

The May 28th decision of DIDC is proper both legally and economically. The decision of the Committee clearly conforms with the directions of the law "to provide for a phase-out of Regulation Q just as soon as is possible." (Conference Report S.R. 96-640, 96th Cong. 2d Sess. 72(1980)), and is within the flexible limits afforded by the law to the DIDC. ("The committee is *not* bound by any target. It may exceed the target if economic conditions warrant. . ." *Id.*) (Emphasis supplied.) Most importantly, however, the rule adopted by the DIDC is in concert with the committee's obligation to see:

> ". . .that the phase-out must be accomplished in a way that ensures equity for depositors, especially those savers with small accounts, and ensures competitive equity among depository institutions and between depository and non-depository institutions that compete for the savings dollar." (Conference Report, p. 73.)

Another misconception which has been directed against Ruling 0008 is that DIDC has placed a "floor" on the interest rates payable on money market certificates. This characterization is completely erroneous. It serves only to show that Reg Q ceilings have been binding for so many years that some institutions have misinterpreted the actual purpose of a ceiling. The regulators are not setting the rate institutions *must* pay; they are setting a maximum *permitted* rate. The purpose of the 6 year transition period is to encourage each institution to evaluate its own situation and learn to set deposit rates based on the conditions under which it operates. The importance of this point cannot be overstated; in the free market environment into which depository institutions are moving, each institution must make its own determination of the deposit rates it will pay independent of its regulation.

In the press release announcing these hearings, Mr. Chairman, you stated that these hearings would look into ". . . rate differentials involving money market certificates." Certainly, our position on the question of rate differentials on any type of deposit is quite clear. We did, however, compromise on this issue by supporting P.L. 96-221, even though it mandates the continuation of the differential on those types of accounts in existence on December 10, 1975. We believe that the imposition of a differential on the money market certificate -- or any other newly created type of deposit -- will be counterproductive, and represents a direct contradiction to the spirit of the Depository Institutions Deregulation Act. Attached to our testimony is a letter to the Deregulation Committee citing data we collected during a survey of 140 community banks in 15 states across the country. The data strongly suggest that most banks are heavily dependent on money market certificates as a source of funds. Moreover, many of the banks that are heavily dependent on MMC's also have high loan/deposit ratios and would encounter severe liquidity problems if they experienced a runoff in the MMCs. Finally a larger number of these banks have a significant portion of their loan portfolio in loans to small business and agriculture or in residential mortgages. These borrowers would obviously be affected by a reduction in the availability of bank credit.

It is unfortunate how some members of the thrift industry have attempted to equate solution of the depression within the homebuilding and real estate industry with their self-protectionist arguments about market rates and the differential. It is claimed that the "market rate" is the rate for Treasury bills. On this point we note only that there was no complaint from the thrift lobbies before June of this year when the interest rate ceiling on Money Market Certificates was 1/4% above the rate for Treasury bills in the case of savings and loans, and equal to the Treasury bill rate in the case of commercial banks, when the Treasury bill was 8-3/4% or less. In point of fact, the savings and loan industry does not object per se to paying rates "above the market rate" by their definition. They object only when commercial banks are given the same right, i.e. when the DIDC attempts to carry out its statutory obligation to ensure competitive equality among depository institutions. The thrift lobby has never leveled with the housing industry about the economic reality that the funds held by banks are fungible so far as investment in housing. Claims that a quarter percent differential will solve the housing problem are absurd. Such claims are shot through with false assumptions. They are predicated on the notions that money in banks will not go to housing (it does, and in greater numbers each year) and that some special "commitment" to housing (a commitment which S & Ls and mutual savings banks have both been moving away from for years) entitles them to anticompetitive advantages. Finally, such claims belie the fact that the American saver is well aware of the investment opportunities available in the money markets outside of regulated depository institutions.

Thus, the real competition to savings and loans comes not from commercial banks able to pay no more than the savings and loans can for Money Market Certificates or Small Saver Certificates; rather, the real competition -- for both of us -- comes from the unregulated non-depository institutions, like Money Market Mutual Funds, which are able to pay a higher rate of return, and thus able to attract the savings of the public away from savings and loans -- and banks. The DIDC has taken a first step toward creating some competitive balance between depository institutions and non-depository institutions, as is its obligation under the law.

Improvement In DIDC Communications

Mr. Chairman, I must add that the Deregulation Committee's May 28 actions have underlined the serious extent of communications problems within the regulatory agencies and between the regulators and the financial community. Bankers are unanimous in their belief that far too short a time period was permitted for everyone to analyze and understand the new rules before those rules took effect; as a result, serious confusion and misunderstandings developed.

It is unrealistic in the highest degree for any group to assume that its decisions can automatically be made known in all their ramifications in the space of four to six working days throughout the financial community. There were not enough telephone lines at the Federal Reserve for that agency even to inform its district and branch offices of the details of the new rules before the rules took effect -- much less for the substance of the rules to be communicated to banks and the thrift industry.

We suggest strongly that in the future the agencies provide a period of several weeks before new rules take effect so that all those who will be subject to the new rules will have a full opportunity to understand them. In the case of the May 28 decisions, the Deregulation Committee could simply have stated that the old rules providing parity on six-month certificates would remain in effect for three weeks (as though the going rate had remained above nine percent), with the new rules to take effect at the end of the three-week period

Housing

The thrift industry has worked long and hard to convince Congress and the regulators that a strong linkage exists between their differential advantage in deposit rate ceilings and the stability of the residential construction industry. The facts, however, do not support this allegation.

Experience over past interest rate cycles clearly shows that deposit rate ceilings -- expecially a differential -- serve only to exacerbate the cyclical nature of the housing industry by artifically restricting the availability of mortgage credit during periods of high market interest rates. In each of the previous interest rate cycles, regulated depository institutions have experienced disintermediation in response to the divergence between deposit ceilings and market rates. Moreover, the slowdown in deposit flows at savings and loans has generally been more severe than those experienced by banks, in spite of their differential rate advantage. It appears that the differential may be responsible for attracting those deposits which are most interest sensitive, thus increasing the vulnerability of S & Ls to disintermediation during periods of high market rates. In any case, the deposit rate ceilings clearly encourage a runoff of funds from all regulated deposit instruments into higher yielding alternative investments. Clearly, the reimposition of any rules limiting lenders' flexibility and power to innovate run contrary to the indisputable facts of the new marketplace. Regulation Q is such a rule. It helps no one, least of all homebuilders, homebuyers and the S & Ls. If depository institutions are to continue to serve as the nation's principal financial intermediaries and mortgage originators, they must be free to compete for deposit funds in the open market.

Housing is at a low period now for many reasons, none of which has anything to do with the May 28th decision of DIDC. Housing has both benefited and been grievously harmed by inflation. Inflation has benefited housing by stimulating the purchase of a home as the best hedge against inflation, and inflation has benefited the home finance market by attracting the interest of lenders and investors other than thrift institutions and banks. Inflation, too, has harmed the housing industry by dramatically increasing the cost of buying or renting decent housing. This burden falls especially hard on young couples buying their first home, the elderly on fixed incomes, and lower-income families. Basically, what is happening in the housing market is that housing costs are accelerating faster than household income, which means that families at all income levels are paying a higher percentage of their income for housing. Nevertheless, despite higher housing costs and relatively high interest rates, we believe that the unmovable object of high mortgage rates will give way to the irresistible force of increasing demand. Congress properly recognized that a significant part of our housing finance problems were the state barriers to the free flow of mortgage funds created by outdated mortgage usury laws, which the Congress wisely preempted in P.L. 96-221. This will help our industry to invest more of our depositors' funds in housing, but the major problem confronting housing is how to keep the economy on an even keel by avoiding spiraling double-digit inflation rates, thus moderating swings in interest rates.

The involvement of commercial banking in home mortgage lending has matured over the past decade as banks have learned about the retail opportunities in residential lending and as they have become aware of the increasing options available in the secondary mortgage markets. Banks are now the second largest source of single-family mortgage loans. For the period 1977-79, outstanding mortgage volume at banks grew 30% faster than that of S & Ls. In general, over the past ten years, banks' share of the residential mortgage origination market has grown -- while S & Ls and others have let their commitment decline. And this in the face of the Reg Q differential and the fact that until 1970 national banks were effectively prevented by law from making mortgages on the same terms as other lenders. Even today, banks are discriminated against by the Federal Home Loan Mortgage Corporation which charges banks a 1/2% higher sales fee than Federal S & Ls must pay for the delivery of mortgages to that secondary market facility.

Attached to this testimony is a statistical summary of the banking industry's investment in housing, real estate and community development activities. We conservatively estimate that banks have committed some $346.3 billion to these sectors of the economy.

The direct home mortgage origination is only one part of a very complex structure that provides money for homebuying. Traditional theories of crisis-management at times when the housing market is depressed have focused only on the one point of direct mortgage origination. Other points must be considered also, and it may be that such other areas will supply the key to unlocking new kinds of home mortgage credit. Pass-though certificates, developed by commercial banks, make it possible for pension funds and investment banking firms to invest in housing. And commercial banks have already contributed much to the growth of the secondary mortgage market.

Another new idea could be to develop the secondary mortgage market further, and to create a widely available mortgaged backed investment instrument that yields a market rate. This could be used to attract funds into housing from still untapped new sources, including pension systems. The stark fact is that banks and S & Ls cannot provide all the funds needed to finance housing. Pension funds and other big investors must be brought into housing finance -- but that cannot happen until the processes of deregulation and innovation make mortgage-backed securities sufficiently attractive.

As the Secretary of the Treasury observed in his testimony of June 21, 1979, before the Senate's Subcommittee on Financial Institutions, conditions in the housing credit markets today are vastly different from what they were in 1966, when the Interest Rate Control Act [P.L. 89-597] was enacted as a temporary measure to prevent interest rate competition among depository institutions.

Since the mid-1960's, federal housing policies have worked well in providing the housing credit market with alternative sources of credit, making housing less sensitive to changes in the flows of funds to thrift institutions. The public sector has become a significant supplier, directly as well as indirectly, of mortgage credit.

The direct intervention of the public sector has principally been through the secondary mortgage market, where both the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation have supplied mortgage credit in a significant volume since 1970.

In 1965, FNMA holdings of home mortgages amounted to $2.5 billion; by 1978 these holdings amounted to $37.6 billion. FHLMC holdings of home mortgages increased from about $400 million in 1970 to $2.5 billion in 1978. Total federal agency holdings of home mortgages (including the holdings on on-budget agencies such as the Government National Mortgage Association, the Farmers Home Administration, the Federal Housing and Veterans Administrations, and the Federal Land Banks) increased from $6.4 billion in 1965 to $35.5 billion in 1976, or by about 455 percent in little over a decade. The rate of growth in these mortgage holdings was most pronounced in the periods of disintermediation. Currently, preliminary data show that total federal agency holdings of home mortgages as of the final quarter of 1978 amounted to about $44 billion.

The public sector has also become a significant indirect supplier of mortgage credit over the last decade or so. This has taken place largely through Federal Home Loan Bank advances to savings and loan associations and the rapidly expanding use of federally-guaranteed securities for the purpose of financing home mortgage pools. The advances of the Federal Home Loan Banks to savings and loan associations have increased sharply in periods of disintermediation. Thus net advances peaked at $5.5 billion in 1966, $9.0 billion in 1970, and

19.2 billion in 1974. Thus far in 1979, advances outstanding have reached $32 billion.

Over the same period, mortgage pools, for which the interest and principal payments are guaranteed by GNMA, also grew notably -- from about $100 million in 1965 to about $66.7 billion at the end of 1978, of which $53.3 billion was held outside of savings and loan associations.

Another factor of difference between the housing market of 1966 and 1979 is that as the largest private capital market in the U.S., this market has become attractive to a variety of other lenders besides the thrift institutions. The recent dramatic rise of pass-through type securities, mortgage-backed bonds and even municipal-bond financing of home mortgage loans through a type of industrial development authority confirms the interest of other lenders in capturing a share of this credit market. Thus, while savings and loan associations hold the largest portion of mortgage debt, with 47% of all 1-4 family mortgage debt, other lenders are actively entering the home mortgage market without the benefit of any interest rate differential, and it can be expected that commercial banks and pension funds will increase their shares of the housing finance market.

Most observers of the residential finance industry who are familiar with the pioneering efforts of commercial banks and investment bankers in the secondary mortgage markets believe that the role of commercial banks will continue to expand in future years. One reason for this is the fact that in P.L. 96-221, the thrift institutions were given in Titles II, III and IV of the Act additional new powers to compete with banks on equal terms in the retail banking area. We believe that this will have an equilibrium effect on the housing finance business because , as some thrift institutions will reduce their specialization in residential mortgage lending, this will provide a new market opportunity for banks.

Finally, Mr. Chairman, as witnessed by the experience of our own institutions, we feel that the role of commercial bnaks in mortgage banking is often overlooked, but yet a source of major financial investment by the banking community to the housing and real estate industry. Mortgage banking, in general, appears to be a growth industry, reflecting investors' growing acceptance of private mortgage insurance and mortgage bonds. Commercial banks(and bank-affiliated mortgage companies) because of their generally larger capital, we believe, are better able to take market risks, an important factor in an environment of unstable interest rates.

CONCLUSION

In summary,

All financial institutions are in an important time of transition with regard to our marketplace. Trying to slow or stop the evolution of a free market is a step backward.

In short, the answer to the housing finance problem is deregulation. Deregulation will permit banks to continue to increase their roles as housing lenders while permitting thrifts to diversify their services. Deregulation will allow new sources of funds to be tapped for housing needs. Deregulation will allow all depository institutions to pay market rates to savers, thus assuring a healthy, stable base for housing and other credit needs. Deregulation also will help all traditional depository institutions to compete with money market muatal funds, which are moving assets away from communtiies and local housing credit needs at a rate of over a billion dollars a month. Deregulation offers fresh solutions to old problems, and will move housing away from boom and bust cycles brought on by artificial stimulents and artificial controls.

Thank you for listening to our views, we look forward to the opportuntiy to answer any questions you might have.

Senator **MORGAN** [presiding]. I believe we will proceed onto all of the statements first.

Mr. Miller, I understand, is going to represent the American Savings & Loan League.

Mr. **MILLER**. That's correct.

Senator **MORGAN**. Mr. Miller, we will be glad to have your remarks.

Mr. **MILLER**. Thank you very much.

Mr. Chairman and members of the Senate Banking Committee, my name is George N. Miller, Jr. I am president of the Community Savings & Loan Association of Newport News, Va., the chairman of the legislative committee of the American Savings & Loan League. Mr. Orlando W. Darden, president of Community Federal Savings & Loan Association, in Washington, D.C., was unable to attend this hearing. I appreciate the opportunity to appear as a member of the legislative committee to present the league's views in opposition to the actions taken by the DIDC to alter the rate structure on 6-month money market certificates and 30-month certificates.

The American Savings & Loan League is a trade organization composed of savings and loan associations in the United States which are owned and/or operated predominantly by blacks, Hispanics, Asian-Americans, and other members of racial or ethnic minorities, formed more than 32 years ago. Its current membership includes 78 savings and loan associations operating in 24 States and the District of Columbia. More than half of the members are federally chartered associations.

The average size of the members of the American League is only $25 million in assets, which is considerably smaller than the average assets size of all other nonminority savings and loan associations.

Because of the generally small size of the minority associations which comprise the American League, the organization is especially sensitive—perhaps uniquely so—to the highly detrimental effects of rule 0008 which was announced by the DIDC on May 28.

In particular, American League members are severely disadvantaged by the additional costs which will result from the increases in interest rate limitations at a time long before they will be permitted or will be able to increase their business by implementing the significant new financial services authorized by other provisions of the act.

DECREASE IN FUNDS FOR LOANS

In addition, because savings and loan associations, as compared to all other financial institutions, make the vast majority of loans to finance the construction, purchase, and improvement of homes, and because one of the direct effects of rule 0008 will be to decrease the funds available to such associations to make such loans, the minority communities served by the membership of the American League will experience a particularly heavy burden in obtaining this critical form of financing.

While it is true that rule 0008 may benefit those savers in a position to take advantage of the increased permissible interest rates on certificates of deposit of $10,000 or more, by far the greatest economic impact of the rule in the communities served by the

American League members will be a limitation on the funds av
able for home mortgages. The combined effect of the reductio
savings deposits in savings and loan associations resulting from
precipitous removal of the differential in interest rates, the ar
cially forced increases in interest rates, and the lack of time
implement the new services authorized by Public Law 96-221
that the economic viability of savings and loan associations—
ticularly small savings and loan associations—will be seriously
paired in direct contravention to the congressionally manda
protection for the viability of depository institutions.

As savings and loan associations return the vast majority of th
funds to their communities in the form of home mortgages, i
quite predictable that the direct effect of rule 0008 will be
significantly decrease the total amount of money available
home purchases and construction and to substantially increase
cost of the mortgage money that is available, and thus furt
aggravate an already severely depressed segment of the econo

It is because of these significant issues which were raised
adoption of rule 0008 that the American League is presenting
testimony today. American League member associations are a
members of the U.S. League and support the testimony of the U
League.

However, the American League would call to your attention
particular effects which the DIDC's unwarranted actions will h
on smaller thrift institutions, such as those which comprise
majority of the American League's membership. The interest r
deregulation provisions of title II of Public Law 96-221, view
within the context of the entire act, make it very clear that C
gress created a package offsetting the adverse effects on th
institutions, of the elimination of interest rate limitations, w
significant new authority to offer a greater variety of services a
hence improve their economic viability.

The squeeze that thrift institutions are thrust into by the prec
tous removal of the differential is most intense for the smal
institutions, such as the American League membership. Such ins
tutions would normally have a greater difficulty in prepari
themselves for the capital investments, new and larger compute
for example, and other startup problems—new staff, for example
associated with offering the complex new services authorized
the act than would larger institutions.

Depriving these smaller institutions of the differential at t
time, contrary to the requirements of title II and the obvious inte
of Congress, announces what may amount to an almost unavo
able destruction of these small institutions. This failure
consider——

Senator Morgan. Mr. Miller, I am sorry to interrupt, but
believe I only have about 3 minutes to vote. So if we will ju
suspend, we will recess momentarily, and then we'll come back.
know it sounds like this is breaking it up, but most of us have re
the statements prior to the time you came here. So we will be rig
back.

[Brief recess.]

The Chairman [presiding]. I understand, Mr. Miller, you were
the middle of a sentence before.

Mr. Miller. Thank you very much, Mr. Chairman.

Depriving these smaller institutions of the differential at this time, contrary to the requirements of title II and the obvious intent of Congress, announces what may amount to an almost unavoidable destruction of these small institutions. This failure to consider the economic viability of such smaller thrift institutions is made painfully clear by an examination of the various DIDC staff reports. While repeated attention is given to the problems faced by smaller commercial banks, nowhere is there any concern shown for the effect of the proposed actions upon smaller thrift institutions.

The DIDC's lack of concern and sensitivity to the needs of minority communities is clear from the total absence of staff analysis of these issues. The American League submits that not only is the DIDC's treatment of this entire matter unfair and an abuse of its authority, it is also certain to have significantly adverse effects upon the continued viability of smaller thrift institutions and thus almost invariably force these institutions into situations where their continued economic viability and existence is questionable.

The overall effect will be to force these smaller community-based and oriented institutions into mergers or other forms of consolidation simply to survive. Thus, the DIDC, which has to take steps to enhance competition, has acted in a manner which will likely produce significant anticompetitive effects which fly directly in the face of the stated national policies designed to stem monopolization and increase competition.

The package created by Congress in Public Law 96-221 has been frustrated by the precipitious and illegal actions of the committee. Rather than being able to compete more effectively, thrifts—particularly smaller thrifts—have been denied their one competitive equalizer, the differential, long before having in place the statutory replacement, new services and powers authorized by titles III and IV.

For all of these reasons, the American League urges that the differential on the money market certificiates and small saver certificates be restored and that any phaseout of the differential and any other interest and dividend rate action affecting thrift institutions may be taken by the DIDC only after thrift institutions have had sufficient time to implement the new powers given to them by Public Law 96-221 and to translate such new powers into increased earnings which would enable thrift institutions to pay market interest rates.

The American League supports the provisions of S. 2927, which would leave the differential in place for 1 year and would also suggest that an express provision be included mandating that any reduction in the differential be taken only after consideration is given to the effects of that reduction on thrifts in the housing industry.

I would be pleased to respond to any questions, Mr. Chairman.

[Complete statement follows:]

STATEMENT OF GEORGE N. MILLER, ON BEHALF OF THE AMERICAN SAVINGS & LOAN LEAGUE, INC.

Mr. Chairman and members of the Senate Banking Committee, my name is George N. Miller. I am President of Community Savings and Loan Association in Newport News, Virginia. The Chairman of the Legislative Committee of the American Savings and Loan League, Mr. Orlando W. Darden, President of Community Federal Savings and Loan Association in Washington, D.C., was unable to attend this hearing. I appreciate the opportunity to appear as a member of the Legislative Committee to present the League's views in opposition to the actions taken by the DIDC to alter the rate structure on 6 month money market certificates and 30 month certificates.

The American Savings and Loan League is a trade organization composed of savings and loan associations in the United States which are owned and/or operated predominately by Blacks, Hispanics, Asian-Americans, and members of other racial or ethnic minorities. Formed more than 32 years ago, its current membership includes 78 savings and loan associations operating in 24 states and the District of Columbia. More than half of the members are federally-chartered associations. The average size of the members of the American League is only $25 million in assets, which is considerably smaller than the average assets size of all other non-minority savings and loan associations.

Because of the generally smaller size of the minority associations which comprise the American League, the organization is especially sensitive, perhaps uniquely so, to the highly detrimental effects of Rule 0008 which was announced by the DIDC on May 28. In particular, American League members severely disadvantaged by the additional costs which will result from the increases in interest rate limitations at a time long before they will be permitted, or will be able, to increase their business by implementing the significant, new financial services authorized by other provisions of the Act. In addition, because savings and loan associations (as compared to all other financial institutions) make the vast majority of loans to finance the construction, purchase and improvement of homes, and because one of the direct effects of Rule 0008 will be to decrease the funds available to such associations to make such loans, the minority communities served by the membership of the America League will experience a particularly heavy burden in obtaining this critical form of financing. While it is true that Rule 0008 may benefit those savers in a position to take advantage of the increased permissible interest rates on certificates of deposit of $10,000 or more, by far the greatest economic impact of the Rule in the communities served by the American League members will be a limitation on the funds available for home mortgages.

The combined effect of the reduction in savings deposits in savings and loan associations resulting from the precipitious removal of the differential in interest rates, the artifically forced increases in interest rates, and the lack of time to implement the new services authorized by the Public Law No. 96-221, is that the economic viability of savings and loan associations, particularly small savings and loan associations, will be seriously impaired in direct contravention of the congressionally mandated protection for the viability of depository institutions. As savings and loan associations return the vast majority of their funds to their communities in the form of home mortgages, it is quite predictable that the direct effect of Rule 0008 will be to significantly decrease the total amount of money available for home purchases and construction and to substantially increase the cost of the mortgage money that is available, and thus further aggravate an already severely depressed segment of the economy. It is because of these significant issues which were raised by adoption of Rule 0008 that the American League is presenting its testimony today.

American League member associations are also members of the U.S. League, and support the testimony of the U.S. League. However, the American League would call to your attention the particular effects which the DIDC's unwarranted actions will have on smaller thrift institutions such as those which comprise the majority of the American League's membership.

The interest rate deregulation provisions of title II of Public Law 96-221, viewed within the context of the entire act, make it very clear that Congress created a "package"; off-setting the adverse effects on thrift institutions of the elimination of interest rate limitations with significant, new authority to offer a greater variety of services and, hence, improve their economic viability. The "squeeze" that thrift institutions are thrust into by the precipitous removal of the differential is most intense for the smaller institutions such as the American League membership. Such institutions would normally have a greater difficulty in preparing themselves for the capital investments (new and larger computers for example) and other startup problems (new staff for example) associated with offering the complex, new services authorized by the Act than would larger institutions. Depriving these smaller institutions of the differential at this time, contrary to the requirements of title II and the obvious intent of Congress, announces what may amount to an almost unavoidable destruction of these small institutions.

This failure to consider the economic viability of such smaller thrift institutions is made painfully clear by an examination of the various DIDC staff reports. While repeated attention is given to the problems faced by smaller commercial banks, nowhere is there any concern shown for the effects of the proposed actions upon smaller thrift institutions. The DIDC's lack of concern and sensitivity to the needs of minority communities is clear from the total absence of staff analysis of these issues.

The American League submits that not only is the DIDC's treatment of this entire matter unfair and an abuse of its authority, it is also certain to have significantly adverse effects upon the continued viability of smaller thrift institutions and thus, almost inevitably, force these institutions into situations where their continued economic viability and existence is questionable. The overall effect will be to force these smaller, community-based and oriented institutions into mergers or other forms of consolidation simply to survive. Thus, the DIDC which has to take steps to enhance competition has acted in a manner which will likely produce significant anti-competitive effects which fly directly in the face of the stated national policies designed to stem monopolization and increase competition. The "package" created by Congress in Public Law 96-211 has been frustrated by the precipitious and illegal actions of the Committee; rather than being able to compete more effectively, thrifts—particularly smaller thrifts have been denied their one competitive equalizer, the differential, long before having in place the statutory replacement, the new services and powers authorized by titles III and IV.

For all of these reasons, the American League urges that the differential on the MMCs and small savers certificates be restored, and that any phase-out of the differential and any other interest and dividend rate action affecting thrift institutions may be taken by the DIDC only after thrift institutions have had sufficient time to implement the new powers given to them by Public Law 96-221, and to translate such new powers into increased earnings which would enable thrift institutions to pay market interest rates.

The American League supports the provisions of S. 2927 which would leave the differential in place for one year, and would also suggest that an express provision be included mandating that any reduction in the differential be taken only after consideration is given to the effect of that reduction on thrifts and the housing industry.

I would be pleased to respond to your questions.

The CHAIRMAN. Mr. Hutchinson, I apologize that we didn't follow the alphabetical procedure, but you're next.

Mr. HUTCHINSON. Thank you, Mr. Chairman.

We have given you a longer statement for the record.

Mr. Chairman and members of the committee, I am John J. Hutchinson, president of the National Association of Federal Credit Unions and manager of the Hamilton Standard Federal Credit Union in Windsor Locks, Conn. The National Association of Federal Credit Unions is the only national trade association exclusively representing the interests of our Nation's federally chartered credit unions. With me today is Dick McConnell, the executive vice president of our association.

The Depository Institutions Deregulation Committee is charged with overseeing the phaseout of interest rate controls "as soon as is possible by increasing the permissible rates paid to depositors on all accounts to market rates."

During congressional consideration of Public Law 96-221 and since the enactment of the bill, various parties questioned whether credit unions should be subject to the DIDC. The fact that credit unions are exempt from the authority of the committee is not an accident of legislative drafting. During conference committee consideration of the bill, H.R. 4986, which led to the establishment of the Deregulation Committee, the conferees reached a consensus that since the stated function of the Deregulation Committee was to increase the rates paid on deposits by depository institutions subject to regulation Q, it would be inappropriate and regressive to place the credit union rate structure temporarily under regulation Q and the authority of the DIDC.

Credit unions were at that time paying and continue to pay today a rate of return closer to a market rate than that permitted by regulation Q. Consequently, to bring credit unions under DIDC control would be a giant step backward.

DEFICIENCIES IN THE OPERATION OF DIDC

There are, however, certain deficiencies in the operation of DIDC. It is slow in response to communications and does a poor job of making known decisions it has made in the course of its meetings. It has unleashed a new flurry of regulations, some of which appear not to be in the purview of a committee whose stated goal, according to the enabling legislation, is the ultimate elimination of regulations.

For example, the DIDC has suggested a ban on premiums offered as a marketing incentive by financial institutions. This seems to be no more than meddling in the operations of these institutions. It is clearly not a reduction in the regulatory burden. The various agencies that supervise financial institutions already have the authority to regulate financial institutions' use of premiums. Controversy has also surrounded the actions of DIDC and of the NCUA in the regulation of money market certificates. DIDC established a complex rate structure designed to enable financial institutions to adjust to changes in the economic marketplace. The NCUA board elected not to merely republish the extremely complex regulation of DIDC and instead adopted a straightforward, easy-to-understand regulation authorizing credit unions to pay what the market demands to a maximum of 9½ percent. The NCUA set an example that the DIDC should follow.

Now, there is consideration being given to reducing the yield on credit union share drafts and other transaction accounts, to equal that paid on NOW accounts. Should this step be taken by DIDC, the credit union community will want to know why, when the DIDC is charged with deregulation, it is issuing new restrictive regulations. The credit union community will want to know why, when the DIDC is charged with eliminating the restrictions of regulation Q, it is trying to bring more institutions under that rule. And credit union members will also want to know why, at a time when consumers are being buffeted by months of high interest rates, tight credit, and deepening recession, the yield on their accounts is being reduced by the Government.

Mr. Chairman and members of the committee, it appears to us that there are two types of questions to be answered about the operation of the DIDC. There are legitimate questions as to whether or not the DIDC is following the mandate of Congress in operating in the sunshine and eliminating regulations.

On the other hand, there are artifical and self-serving questions circulating about the composition of the DIDC and the failure of the DIDC to maintain and strengthen Government involvement in the marketplace.

Mr. Chairman, the National Association of Federal Credit Unions has been on record for more than 5 years as an opponent of regulation Q and other similar interest rate restrictions. Certain instabilities in the marketplace might dictate a phaseout rather than an abrupt end to regulation Q. But these instabilities certainly do not demand reinforcement of the already artificial rate structure or the expansion of that structure to include more consumers.

One effort to solve some of these problems, S. 2927, would limit the authority of DIDC by prescribing an interest rate differential on deposits and accounts in insured banks and savings institutions. Introduced on July 2 by Senator Morgan, and cosponsored by Senators Garn, Riegle, and others, this bill would provide for the scheduled phaseout of the differential.

Mr. Chairman and members of the committee, prior to enactment of the Depository Institutions Deregulation Act of 1980, a variety of similar ratcheting proposals designed to phase out regulation Q were considered and rejected.

In summary, the National Association of Federal Credit Unions firmly believes that DIDC should do exactly what Congress has told it to do: It should diminish the regulatory burden now imposed on financial institutions as quickly as possible, and it should adjust interest rates as fast as economic stability allows, by permitting financial institutions to respond to market conditions without any artificial limitations. If these actions are taken, the financial institutions and the consumers they serve will be the winners, and further legislation will not be needed.

Mr. Chairman, this concludes my testimony. I will be happy to answer any questions.

[The complete statement follows:]

STATEMENT OF JOHN J. HUTCHINSON, PRESIDENT, THE NATIONAL ASSOCIATION OF FEDERAL CREDIT UNIONS

Mr. Chairman, members of the Committee on Banking, Housing and Urban Affairs. I am John J. Hutchinson, president of the National Association of Federal Credit Unions and manager of Hamilton Standard Federal Credit Union in Windsor Locks, Conn. The National Association of Federal Credit Unions (NAFCU) is the only national trade association exclusively representing the interests of our nation's federally chartered credit unions. I appreciate the opportunity to appear before you today to present the views of NAFCU as you conduct oversight hearings regarding the organization and actions of the recently created Depository Institutions Deregulation Committee (DIDC). As requested by the Chairman, I will also comment on S. 2927, a bill which would prescribe an interest rate differential on deposits and accounts in insured banks and savings institutions. With me today is Dick McConnell, the executive vice president of our association.

The Depository Institutions Deregulation Committee (DIDC), authorized by Section 203 of Public Law 96-221, consists of the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Chairman of the Board of Directors of the Federal Deposit Insurance Corporation, the Chairman of the Federal Home Loan Bank Board, and the Chairman of the National Credit Union Administration Board, who are voting members of the DIDC, and the Comptroller of the Currency, who is a non-voting member of the DIDC. The Deregulation Committee is charged with overseeing the orderly phase-out of interest rate controls "just as soon as is possible by increasing the permissible rates paid to depositors on all accounts to market rates . . ." (Senate Report 96-640 at 72; House Report 96-842 at 72). The statute creating the Deregulation Committee stipulates that the committee's authority will expire and the committee itself will go out of existence on March 31, 1986, six years from the date of enactment of the statute.

While credit unions are explicitly exempted from the regulatory authority vested in the Deregulation Committee, they are nevertheless affected by DIDC actions. As evidence of this fact, all one must do is review the brief history of the DIDC. The Deregulation Committee has held three public meetings to date. Following each public meeting of the Deregulation Committee, the National Credit Union Administration Board has convened to address substantially the same issues. I shall return to the subject of DIDC proposals and related NCUA proposals in a few moments, but first would like to examine what I consider to be some very fundamental issues which have been raised regarding credit union exemption from DIDC authority, the structure of the Deregulation Committee, and the procedures that have been followed by the committee.

CREDIT UNION EXEMPTION FROM DIDC AUTHORITY

During Congressional consideration of Public Law 96-221, and since the enactment of that comprehensive financial reform bill, various parties have questioned whether credit unions should or should not be subject to the regulations promulgated by the DIDC. The fact that credit unions are exempt from the authority of the Deregulation Committee is not an accident of hasty legislative drafting. Indeed, that precise question was raised by the Chairman of this Committee on March 5 of this year during the conference committee consideration of the bill (H.R. 4986) which led to the establishment of the Depository Institutions Deregulation Committee. At that time, the conferees reached a consensus that since the stated function of the Deregulation Committee was to increase the rates paid on deposits by depository institutions subject to Regulation Q, it would be inappropriate and regressive to place the credit union rate structure temporarily under Regulation Q and the authority of the DIDC. Credit unions were at that time paying, and continue today to pay, a rate of return closer to a market rate than that permitted by Regulation Q.

I might add, Mr. Chairman and members of the Committee, that to place credit unions under the regulatory authority of the Deregulation Committee would require change in the statutory language of Public Law 96-221. I make this observation after having reviewed that statute thoroughly. Section 202(b) states very clearly that: It is the purpose of this title to provide for the orderly phase-out and the ultimate elimination of the limitations on the maximum rates of interest and dividends which may be paid on deposits and accounts by depository institutions . . . [and] to ensure a phase-out of such limitations to market rates of interest.

Section 802 of the same law is equally clear in its mandate that: Regulations should achieve legislative goals effectively and efficiently. Regulations should not impose unnecessary costs and paperwork burdens on the economy, on financial institutions, or on consumers.

Clearly, it is both the letter and the intention of the law that credit unions should not be under the control of the Depository Institutions Deregulation Committee. The rate structure under which credit unions now operate already approaches the situation to which the DIDC is attempting to bring other depository institutions. To bring them under DIDC control would be a giant step backwards.

THE STRUCTURE OF DIDC

Turning now to the structure of DIDC, I would like to address those suggestions that the committee be expanded to include representatives of the Department of Housing and Urban Development or other groups to restore a balance toward mortgage lending. Mr. Chairman, the National Association of Federal Credit Unions and the credit union community as a whole are strongly supportive of any effort to restore a healthy market for residential mortgage lending in our country. Just two years ago, this association worked diligently to secure mortgage lending authority for credit unions. This effort, thanks in large part to the work of this Committee, was successful.

But our commitment to a stable residential mortgage market is unrelated to the structure of DIDC. The DIDC was established to assist depository institutions in solving many of the problems they face in an economic marketplace that is difficult enough in itself, and one that has been made more difficult by the artificial interventions of government. To suggest that the committee has a bias against housing, is, to my mind, absurd. It is more accurate to say that the committee has a variety of concerns and that housing is one of them. On several occasions in the recent past, the housing problem has been the tail wagging the dog of financial reform. To restructure DIDC by adding representatives of agencies that are not depository institutions will continue this anomaly.

In addition, reading between the lines of the proposal to add the Secretary of HUD to the DIDC, I get the distinct impression that such an addition would make it easier to thwart the fundamental purpose of the DIDC, which is: the elimination of an artificial rate structure and the return of financial institution savings rates to the marketplace. If this is the case, it clearly would not improve the operation of DIDC, but rather sidetrack the mandate imposed on the committee by legislation.

PROCEDURES OF DIDC

With that said, I am afraid I must also address certain deficiencies in the operation of DIDC itself. Frankly, there seems to be a difference between what the DIDC understands itself to be and what the Congress intended it to be. In the debate over the establishment of the DIDC, it appeared it was to be a committee that would operate in the open light of day with a clear mandate from Congress, and with an eye toward reducing the intervention of government in financial institutions' operation. In fact, some of the actions of the DIDC would lead one to believe it is operating as a super and secret regulatory agency. At times its meetings have been held at odd hours, effectively barring large segments of the public from observing its deliberations. It is slow in response to communications, and does a poor job of making known decisions it has made in the course of its meetings. It has unleashed a new flurry of regulations, some of which appear not to be in the purview of a committee whose stated goal, according to the enabling legislation, is the ultimate elimination of regulations.

REGULATORY PROPOSALS: DIDC/NCUA

For example, the DIDC has suggested a ban on premiums offered as a marketing incentive by financial institutions. This certainly seems to be no more than meddling in the operations of these institutions. It is clearly not a reduction in the regulatory burden, and it would add to existing regulatory agencies a new level of authority. The various independent agencies that supervise federally chartered financial institutions have, and have used, their authority to regulate financial institutions' use of premiums. There have been abuses in this area, but the regulations are clear enough. Where financial institutions have failed to obey existing regulations, and where financial institution regulators fail to enforce existing regulations, it appears the answer should be more stringent observation and enforcement of those existing regulations, not the creation of new regulations.

Controversy has also surrounded the operation of DIDC and of the NCUA in the regulation of money market certificates. As you know, the DIDC established a complex rate structure designed to enable financial institutions to adjust to changes in the economic marketplace. This change reduced the rate advantage now enjoyed in some circumstances by the mutual savings banks and the savings and loans. As you also know, the NCUA Board elected not to merely re-publish the extremely complex regulation of DIDC and instead adopted a straightforward, easy-to-understand regulation authorizing credit unions to pay what the market demands, to a maximum of 9½ percent.

Controversy over these two actions has centered on the differential advantage lost, and the gain of the market advantage by credit unions. It appears to the National Association of Federal Credit Unions that there should have been controversy about the DIDC actions, but not the controversy that took place. Why was there little controversy over the complexity of the rule? Why was there little controversy over the artificial government-imposed limits? The NCUA set an example the DIDC should follow. NCUA forthrightly rejected the mind-numbing complexities of the DIDC rule and decided to let credit unions, their members and the marketplace work out the rate structure. Perhaps NCUA, in drafting its money market certificate regulation, kept in mind the admonition contained in Title VIII of Public Law 96-221: "Regulations should achieve legislative goals effectively and efficiently."

In addition, it appears that a new controversy is on the horizon. This time there is consideration being given to reducing the yield on credit union share drafts and other transaction accounts to equal that paid on NOW accounts. Should this step be taken by DIDC and should NCUA support it, there will be new controversies. The credit union community will want to know why, when the DIDC is charged with deregulation, it is issuing new restrictive regulations. The credit union community will want to know why, when the DIDC is charged with eliminating the restrictions of Regulation Q, it elected to bring more institutions under that rule. And credit union members will want to know why, at a time when consumers are being buffeted by months of high interest rates, tight credit, and now deepening recession, the yield on their accounts is being reduced by the government. On the other hand, if DIDC should recommend reducing the yield on credit union share drafts and other transaction accounts to equal that paid on NOW accounts and NCUA should oppose the proposal (as NAFCU strongly believes it should), then NCUA would be subject to intense criticism from individuals outside the credit union community for simply exercising the regulatory authority properly vested in it by the Congress.

In summary, it appears to us that there are two types of questions to be answered about the operation of the DIDC. On the one hand, there are legitimate questions as to whether or not the DIDC is following the mandate of Congress in operating in the sunshine and eliminating regulations. On the one hand, there are artificial and self-serving questions circulating about the composition of the DIDC and the failure of the DIDC to maintain and strengthen government involvement in the marketplace. Mr. Chairman, the National Association of Federal Credit Unions has been on record for more than five years as an opponent of Regulation Q and other similar interest rate restrictions. Certain instabilities in the marketplace might dictate a phase-out rather than an abrupt end to Regulation Q, but these instabilities certainly do not demand reinforcement of the already bizarre artificial rate structure, or the expansion of that structure to include more consumers.

S. 2927

The DIDC has been the subject of much criticism during recent months; criticism echoed by most of the witnesses appearing before this Committee today. Some would have the DIDC abolished, while others would have the Congress define more precisely the mandate of the DIDC.

One bill, S. 2927, would limit the authority of the DIDC by prescribing an interest rate differential on deposits and accounts in insured banks and savings institutions. Introduced on July 2 by Senator Morgan, and cosponsored by Senators Garn, Riegle and others, this bill would provide for an orderly phase-out of the differential by retaining for the next twelve months the one quarter point differential. The next year the differential would decline to 20 basis points. Each year thereafter it would decline by five basis points so that, by the end of five years the differential would be eliminated.

Mr. Chairman and members of the Committee: prior to enactment of the "Depository Institutions Deregulation Act of 1980" (Pub. L. 96-221, Title II) a variety of ratcheting proposals designed to phase-out Regulation Q in an orderly fashion by a certain date were considered by this Committee and its counterpart in the House. In fact, H.R. 4986 as it was initially approved by the Senate on November 1, 1979, provided for a two year extension of existing Regulation Q authority. In addition the Senate amendment further provided for an upward "ratcheting" of rate ceilings on all types of deposits beginning on January 1, 1982, and ending January 1, 1989. In conference this provision was rejected, and the DIDC as we now know it approved.

As we have testified before this and other Congressional committees in the past, the National Association of Federal Credit Unions believes that it is in the best interest of the American consumer, the small saver, that Regulation Q—which we view as an artificial restraint on consumers' potential earnings—be eliminated as quickly as feasible. If this is done, then the rates paid by depository institutions would more appropriately reflect each institution's response to marketplace conditions. Only then will depositors be assured of an equitable return on their savings, regardless of the institution selected to act as the depository of those savings.

CONCLUSION

At present, the DIDC is the only existing structure that is aggressively pursuing the goal of allowing a free marketplace to determine the return savers should receive on their funds. Yet as I and others have testified before you today, the DIDC has many operational deficiencies. It clearly needs to have its Congressional mandate clarified. While a statutory amendment may in time prove to be necessary in order to rein in this super agency, in fact all that is needed is compliance with an already stated Congressional intent.

The National Association of Federal Credit Unions firmly believes that the DIDC should do exactly what Congress has told it to do: it should diminish the regulatory burden now imposed on financial institutions as quickly as possible, and it should adjust interest rates as fast as economic stability allows by permitting financial institutions to respond to market conditions without any artificial limitations. If these actions are taken, the financial institutions and the consumers they serve will be the winners.

Mr. Chairman, this concludes my testimony. I'll be happy to answer any questions the subcommittee may have.

The CHAIRMAN. Thank you very much. Mr. Klaman?

Mr. KLAMAN. Thank you very much, Mr. Chairman. I have brought my own electronic timing device which will let me know 30 seconds before my time expires.

The CHAIRMAN. Is that a premium prize?

Mr. KLAMAN. Not really. [Laughter.]

But I'll tell you where you can get it.

My name is Saul B. Klaman, Mr. Chairman. I am president of the National Association of Mutual Savings Banks. I am glad to be here today.

The action taken by the DIDC, in our judgment, was ill-timed and ill-conceived, and arouses our very deep concern. The regulation Q changes announced on May 28 have harmful implications, not only for thrift institutions but for housing and the economy. Importantly, they introduce major new complexities, which is an anomaly for a Deregulation Committee to take as its first step. These actions don't inspire confidence that the process of deregulation will be carried out by the DIDC in a manner consistent with congressional intent.

It is essential, therefore, that the Congress, if it shares our concern, make its views unmistakably clear to the DIDC, in order to assure an orderly and balanced approach to deregulation in the years ahead. This may well require new legislation, particularly with respect to the differential on types of accounts introduced since 1975.

The May 28 actions are particularly difficult to reconcile with a balanced and orderly approach to deregulation which we thought was the objective of the Congress. Barely 2 months after coming into existence, the deregulation committee made a number of far-reaching changes which you have set forth in our more detailed statement.

EROSION OF THE MMC DIFFERENTIAL

In particular, we find most objectionable the erosion of the MMC differential. The best that can be said about this, I think, is that it was highly premature. It was prompted, clearly, by their own statements, by the reappearance of the MMC differential when 6-month Treasury bill rates fell below 9 percent in mid-May. It was motivated by concern that some commercial banks, the smaller ones, might consequently encounter difficulties in rolling over maturing MMC's.

Now, there could not have been any evidence to this effect, because not enough time had elapsed. In fact, it hadn't been done. So the precipitous response of the regulatory authorities in this instance contrasts very sharply with the record of inaction during the recent period of unprecedented disintermediation at savings banks, 1979 and early 1980.

We importuned the committee on several occasions that it would be appropriate to restore that differential because of the severe outflows we were experiencing. In fact, we experienced 13 months' consecutive outflow, $11 billion worth. In order to mitigate deposit outflows from thrift institutions and cushion the increasingly harsh impact on housing, we talked to the committee members, the old committee format, several times, and they failed to take action, as I said, and our importuning was without avail. Yet the moment that the differential was kicked back in by market forces, they moved with amazing haste to forestall anticipated rather than actual deposit losses.

This is what really continues to remain inconceivable to us: that they took this action in the absence of evidence. They were after us for months to provide them with evidence of actual outflows and serious weakening so that I find their action to be astonishingly quick and hard to justify.

I think in view of these elements that Congress should indeed give serious consideration to directing the committee to take action it considers desirable, to, in effect, instruct them. I think this would include the extension of present statutory protection to differential and types of accounts existing in December 1975, to new types of accounts introduced after that date. And in this regard, Senator Morgan's bill, cosponsored by others, S. 2927, is certainly a step in this direction.

It provides for the differential for post-1975 types of accounts, but with a 5-year phaseout. We're very gratified that this kind of legislation on the differential is at last being provided.

We would prefer, clearly, that the differential not be phased out in this period. We think that a quarter of a point differential is small enough, and in effect, provides for a phaseout all the time, rather than having to go down as low as five basis points.

I have some comments, Mr. Chairman, in the area of transaction accounts, which—the committee will be addressing the regulation very shortly, which give us some concern. You may want to get into that later, but I am particularly concerned that they may require a decline in rates which we already are offering or even an increase in the passbook rate, which I think would be premature. Either way, it's an anomaly, and very difficult to handle.

URGE PROHIBITION OF FINDERS' FEES

Finally, the question was raised this morning about premium campaigns, finders' fees. I want to make it clear that our position—and the savings bank industry is located in an area in the where this is really a major center of such competition—we would urge at least the prohibition of finders' fees. These ought to be considered separate and apart from the premium campaign. That's not a little teddy bear or a dog. That's $1,200 to an individual who brings a friend in, and there's a real question of who gets the money.

Obviously, I think that's a direct, outright violation of the statute. And we have taken positions on this, and we feel that it's just not possible to take such action unilaterally when you're dependent on markets from New York City. We do recognize the need for exceptions in the case of branch openings and so forth, but otherwise, I think we had a choice we would like to get rid of them.

I see that my time is about to expire. You heard that?

The CHAIRMAN. There you go. Right.

Mr. KLAMAN. I therefore conclude my statement, Mr. Chairman. Thank you very much.

[The complete statement follows:]

Statement
of the
National Association of Mutual Savings Banks
on the
Depository Institutions Deregulation Committee
before the
Committee on Banking, Housing and Urban Affairs
United States Senate
August 5, 1980

Mr. Chairman, my name is Saul B. Klaman. I am President of the National Association of Mutual Savings Banks.

I appreciate the opportunity to present the views of the mutual savings bank industry on the actions of the Depository Institutions Deregulation Committee (DIDC). That Committee is, of course, responsible for establishing deposit rate ceilings during the 6-year Regulation Q phase-out period provided by legislation passed by the Congress in March of this year. In performing this function, the DIDC can have an enormous impact, not only on depository institutions but on other broad sectors of the economy.

Summary Appraisal of DIDC Actions

The actions taken by the DIDC in its brief existence arouse our deepest concern. The Regulation Q changes announced on May 28 were extremely ill-advised and ill-timed. These changes have harmful implications for thrift institutions, for housing and for the economy. They introduced major new complexities in the deposit rate structure and can hardly be justified as a step toward deregulation. These actions do not inspire confidence that the process of deregulation will be carried out by DIDC in a manner consistent with the Congressional intent.

Accordingly, we believe that these hearings are of critical importance. It is essential that the Senate Banking Committee and the Congress be fully informed of the nature and consequences of the Deregulation Committee's actions. It is essential also that the Congress, if it shares our concerns, make its views unmistakably clear to the DIDC, in order to assure an orderly and balanced approach to deregulation in the years ahead. This may well require new legislation, particularly with respect to the differential on types of accounts introduced since 1975.

Responsibilities of DIDC

Before detailing our objections to the May 28 Regulation Q actions, it is useful to emphasize that our industry strongly supported the Depository Institutions Deregulation and Monetary Control Act (H.R. 4986, Public Law 96-221) which established the DIDC. We continue to believe that this legislation, taken as a whole, represents a balanced approach to the interrelated issues of Regulation Q and broadened powers for thrift institutions. We are gratified that the Congress, and particularly the Senate and its conferees on H.R. 4986, recognized that savings banks need broadened asset and liability powers, and time to implement them, in order to operate in a non-Q environment.

It is evident that this legislation also sought to provide a realistic approach to the specific responsibilities of the DIDC in administering the phase-out of Regulation Q (Title II of P.L. 96-221). Thus, the DIDC is directed to provide for the "orderly" phase-out of limitations on maximum deposit interest rates "as rapidly as economic conditions warrant" and a series of targeted increases in ceiling rates is provided to guide the

Committee. The Committee is instructed to work toward market rates of return to savers but "with due regard for the safety and soundness of depository institutions." The Committee, moreover, is explicitly prohibited from increasing limitations on maximum deposit rates "above market rates" during the 6-year phase-out period.

The directive to the DIDC also reflects clear recognition by the Congress of the critical importance of the thrift institution differential as long as deposit rate control authority exists. Thus, each member of DIDC is separately required to report to the Congress annually regarding the economic viability of depository institutions, including an assessment of whether the removal of any differential between commercial banks and thrift institutions will adversely affect the housing finance market or the viability of the thrift industry.

The May 28 Actions

The May 28 actions are difficult to reconcile with the balanced and orderly approach obviously sought by the Congress. Barely two months after coming into existence, DIDC made the following far-reaching changes in ceiling rates on 6-month and 30-month market-linked certificates:

1. The thrift institution differential on 6-month MMCs was further restricted. Originally, a 1/4 per cent differential was applicable at all times. In March 1979, the differential was removed whenever Treasury bill rates are above 9 per cent. Now, a differential exists only when 6-month Treasury bill rates are between 7.26 and 8.74 per cent, while the full 1/4 per cent is applicable only when bill rates are between 7.50 and 8.50 per cent.
2. Holders of maturing 6-month MMCs at commercial banks were permitted to roll over their accounts at the higher thrift institution rate during the next 6 months, thereby further restricting the differential.

3. Minimum ceilings were established for 6-month and 30-month CDs and are applicable no matter how far Treasury rates decline.

4. Ceiling rates were raised, generally by 1/4 per cent for 6-month MMCs and by 1/2 per cent for 30-month CDs, for all types of institutions.

The DIDC might argue that these changes were made for the good of depository institutions in order to strengthen their competitive position relative to money market funds. This argument has little merit as far as thrift institutions are concerned. Any improvement in the thrift institution competitive position relative to money market funds is likely to be more than offset by increased weakness relative to commercial banks. In any event, money market funds have continued to grow rapidly since the recent Regulation Q changes, and their assets increased by $10.3 billion from May 28 to July 23, reaching a total of $79.1 billion. On the other hand, savings banks in June sustained a $100 million net deposit outflow, excluding interest credited to depositors' accounts. Including interest, savings banks gained $1.7 billion in June, while deposits outstanding totaled $148 billion.

The further erosion of the thrift institution MMC differential was particularly objectionable. The best that can be said for this action is that it was highly premature, given the recent disintermediation experience of savings banks, as well as the lack of any evidence that such action was needed to meet deposit flow problems at commercial banks.

The action was apparently prompted by the reappearance of the MMC differential when 6-month Treasury bill rates declined below 9 per cent in mid-May. It was motivated, we understand, by concern that some commercial banks might consequently encounter difficulties in rolling over maturing MMCs. To our knowledge, no evidence of such difficulties at commercial banks existed when the action was taken. Indeed, since the reappearance of the differential was so brief, such evidence could hardly have existed at that time.

The precipitous response of the regulatory authorities in this instance contrasts with their record of inaction during the recent period of unprecedented disintermediation at savings banks in 1979 and early 1980. Following the March 1979 action eliminating the MMC differential at bill rates above 9 per cent, the savings bank industry as a whole suffered 13 consecutive months of continuous deposit losses, totaling $11.3 billion, before interest credited to depositors' accounts. Because of the loss of the differential, the savings bank share of total MMC growth declined from 16 per cent prior to March 1979 to 10 per cent following that action. In contrast, the commercial bank share increased from 30 to 48 per cent.

In order to mitigate deposit outflows at thrift institutions and to cushion the increasingly harsh impact on housing, we repeatedly urged restoration of the differential on MMCs. After failing to take such action during the long and difficult disintermediation period at thrift institutions, the regulatory authorities then moved with great haste to forestall anticipated, rather than actual, deposit losses at commercial banks. It remains inconceivable to us that the DIDC restricted the MMC differential in the absence of actual evidence of adverse impact on commercial banks.

The action is equally difficult to understand or justify, in view of the recent disastrous decline in housing activity. Weakening the differential on MMCs will obviously aggravate the housing situation, by encouraging shifts of funds from thrift institution to commercial banks. Thus, the restriction of the differential means that housing will revive more slowly than would otherwise have been the case and this, in turn, will retard a general economic recovery.

In view of these factors, the Congress should give serious consideration to extending the present statutory protection for the differential on types of accounts existing in December 1975 to new types of accounts introduced after that date. Market-linked accounts currently represent 36 per cent of total savings bank deposits. The importance of "post-1975" types of accounts, moreover, is likely to increase during the 6-year Regulation Q phase-out period. Unless action is taken, the current statutory protection for the differential will become increasingly meaningless. We believe that maintaining the differential during the 6-year phase-out period would be consistent with the broad intent of the Congress.

In this regard, S. 2927 would provide for a statutory differential for "post-1975" types of accounts. On the other hand, the differential would be phased out over 5 years by 5 basis points a year. We are gratified by this recognition that legislative action is needed to preserve at least some of the differential. We believe, however, that the phase-out prescribed by S. 2927 is too rigid. We continue to believe that the full differential is warranted as long as deposit interest rate ceilings are maintained.

The minimum ceilings on 6-month and 30-month certificates also have serious implications for thrift institutions and housing. Contrary to one of the basic purposes of market-linked accounts, ceilings may be maintained well above market levels in a climate of easing financial conditions. As a result, interest cost pressures on thrift institutions will be prolonged and aggravated. Minimum ceilings on market-linked accounts, therefore, will tend to establish a floor under mortgage interest rates. This will lessen the chances of further reduction in mortgage interest rates to the obvious detriment of home buyers.

The impact of minimum ceilings on thrift institutions will be unfavorable both in the short- and long-run. Even before this change, earnings positions of savings banks were deteriorating rapidly. Bottom-line net income of savings banks in the first quarter of 1980 was 40 per cent below a year earlier. The decline would have been far greater except for penalty income from premature withdrawals from existing time accounts. With the reduction in such penalty income, net income has decreased further for the industry as a whole, according to preliminary indications. Currently, a substantial number of individual savings banks are operating in the red. The minimum ceilings will prolong this unfavorable earnings situation. Nor is there any indication, as discussed earlier, that the minimum ceilings have significantly affected the ability of thrift institutions to compete with money market funds.

Finally, it is ironic that one of the first actions of the Deregulation Committee was to introduce new complexities in the regulation of deposit rate ceilings. With regard to the minimum ceilings, for example, it would seem far more consistent with the philosophy of deregulation if rates on 6-month and 30-month CDs had been permitted to decline along with the market.

Rate Ceilings on Interest-Bearing Transaction Accounts

In the area of transaction accounts, the DIDC has requested comments on various options for changes in interest rate ceilings on such acccounts. These options essentially involve choices between rate increases on passbook savings accounts, which savings banks cannot afford at this time, and reductions in transaction account ceilings, which are undesirable from the standpoint of consumers. We have a number of serious concerns regarding these proposals.

First, an increase in the passbook rate ceiling at this time would have a serious impact on already weakened earnings positions at savings banks without attracting significant deposit inflows.

Second, the proposed definition of transaction accounts is excessively broad and encompasses many different types of accounts which have only incidental transaction features.

An excessively broad transaction account definition is objectionable in a number of respects. It would inhibit innovation in deposit services, since the addition of convenience features to savings accounts could trigger a rate reduction as well as reserve requirements under current proposals. It would also further erode the thrift institution differential provided by the Congress, since some savings accounts would be reclassified as transaction accounts and subject to ceiling rates that are uniform for both commercial banks and thrift institutions.

In view of these considerations, we believe that action on transaction account ceiling rates should not be undertaken at this time. The issues raised by the DIDC can be more readily resolved within the context of the Depository Institutions Deregulation and Monetary Control Act. That Act requires the DIDC to vote, not later than 18 months after enactment, on whether to increase the rate ceiling on passbook savings accounts by at least 1/4 of one per cent. We believe that action on transaction account ceilings should be postponed until a decision is made on passbook rate ceilings consistent with the timing of the targeted deregulation prescribed by the Congress.

Regulatory proposals relating to transaction accounts at depository institutions raise again the issue of reserve requirements on money market funds. Since reserve requirements have been applied to transaction accounts at depository institutions, it seems clear that similar requirements should be extended to money market funds which offer transaction features.

Proposed Ban on Premiums

The Deregulation Committee has also proposed a ban on premiums or gifts to depositors. The comment period has been repeatedly extended. On June 25, moreover, the Committee indicated that any prohibition that might be adopted will not be applicable until the end of 1980.

Gift campaigns in some market areas have escalated to such a point that regulatory action is needed to reestablish orderly conditions. These campaigns have continued unabated in these areas, despite the dramatic decline in open-market interest rates and the resulting improvement in deposit flows. The persistence of these campaigns largely reflects the difficulty faced by individual institutions in discontinuing gift campaigns because of the threat of large-scale shifts of funds to other institutions. Premium campaigns of such intensity represent an inefficient means of rewarding savers, serve little useful purpose in strengthening overall industry deposit flows and merely strain already weakened earnings positions.

The National Association's preferred approach to the problem is to: (1) prohibit entirely "finder's fees" and gifts for "friends" since this is the area of greatest abuse; and (2) permit limited campaigns only in connection with new offices, where such campaigns perform a useful function.

With respect to finders' fees, which are frequently paid in cash, a prohibition could be immediately implemented. Whatever reasons there may be for the DIDC's decision to postpone action on premiums, these reasons would seem to be inapplicable in the area of finders' fees. With respect to new offices, we recognize the view that exceptions for new offices or other purposes are impractical from the standpoint of enforcement. Confronted by an all or nothing choice, our Association has concluded that a total ban on premiums is preferable to no action at all. It should be emphasized, however, that this conclusion was reached in the face of indications that the regulatory authorities were unable to enforce their regulations limiting the value of gifts that are offered.

In conclusion, Mr. Chairman, our industry commends your efforts, as reflected in these hearings, to assure that the intent of the Congress in adopting the Depository Institutions Deregulation Act is in fact achieved.

The **Chairman**. Mr. Klaman, you're one person who will never have to be wired for sound. I think Senator Morgan is right, we ought to fix all of our witnesses up with that kind of a device. Mr. O'Brien?

Mr. **O'Brien**. Thank you, Mr. Chairman. You have my prepared testimony, and I will read a brief summary.

My name is Robert O'Brien. I am president of Carteret Savings & Loan Association of Newark, N.J. I appear before you today as chairman of the Government Affairs Committee of the National Saving and Loan League.

Public Law 96-221, the legislation which President Carter signed on March 31 of this year, provided for an orderly phaseout of interest rate controls over a 6-year period. Section 204 of the act instructs the DIDC "to provide for the orderly phaseout and ultimate elimination of the limitations on the maximum rate of interest and dividends which may be paid on deposits and accounts as rapidly as economic conditions warrant."

That's a quote. The section also admonishes the DIDC to use its authority "with due regard for the safety and soundness of depository institutions," and to bring interest ceilings in line with market rates "as soon as feasible, except that the Deregulation Committee shall not increase such limitations above market rates during the 6-year period beginning on the date of the enactment of this title."

The Conference Report on H.R. 4986 furthermore clarifies the intent of Congress that the 6-year term for phasing out the interest rate controls was decided upon "in order to give thrift institutions time to incorporate the new powers granted to them so they may increase their earnings and be in a position to attract deposits by paying market interest rates."

On May 28, the DIDC voted to freeze the interest rate ceiling on the 6-month MMC and the 30-month small savers' certificate, regardless of how low the Treasury bill rate may fall. The committee limited the range in which a differential might exist on MMC's and permitted commercial banks to roll over existing MMC's at the thrift rate.

Such an action can hardly be consistent with the intent of the act that savings rate be adjusted with market rates "as rapidly as economic conditions warrant * * * with due regard to the safety and soundness of depository institutions."

Furthermore, it contradicts, in our view, the statutory language that forbids the DIDC from setting the regulation Q ceilings above market rates. The action of the DIDC clearly flies in the face of the conference report statement that thrifts would need a 6-year time period to incorporate the new investment powers and services. The arbitrary floors in the MMC and small savings certificate rates have virtually locked in mortgage rates of 11.5 percent or more, and it is clear that most potential home buyers cannot qualify for mortgage loans at these high rates.

SAVERS BECOME HIGHLY RATE SENSITIVE

Mr. Chairman, savers today have become highly rate sensitive, particularly those savers who use the MMC and SSC's. To suggest that institutions can pay less than the regulation Q ceilings is to ignore the realities of the marketplace and the highly competitive nature of the consumer savings market.

Competition will always keep money market certificates and small savers' certificate rates at the maximum. That is why it is imperative that if we are to have any hope of returning to affordable mortgage rates, the DIDC decision of May 28 must be reversed.

The actions of the DIDC can hardly be viewed as consistent with the safety and soundness language of section 204. For several months prior to May 28, thrift institutions experienced unprecedented increases in their cost of funds, as a direct result of rising interest rates induced by the Fed. The earnings position of the thrift institution was getting steadily worse. For the first time, the industry as a whole had negative earnings the second quarter of this year. Because of the DIDC actions, the savings and loan industry will continue to show negative earnings this quarter.

Savings and loan mortgage lending is 60 percent lower than a year ago. We saw withdrawals exceed new savings by $250 million in June, the first month under the new antihousing DIDC policy. The predictible age distribution pattern, family formation rate, and other demographic estimates, plus estimates of expected losses in the housing stock, suggest that we need to build 2.2 million new housing units a year in the 1980's.

This forecast, along with the DIDC action, asks a critical question: Is housing still a national priority? That question can only be definitively answered by the Congress. If the Congress will act to reverse the May 28 decision and give clear directives to the DIDC, it will be giving an affirmative answer.

In conclusion, Mr. Chairman, we are here today to plead the case of housing and the continued opportunity for American families to own their own homes. Specifically, we urge the Congress to direct the DIDC to: First, maintain an interest rate differential on all savings accounts covered by regulation Q; second, define market rate for title II purposes as Treasury bill rates of comparable maturities; third, prohibit the DIDC from creating artificial minimum ceilings on instruments designed to fluctuate with the market; lastly, make all regulation Q adjustment decisions by unanimous vote.

Thank you, Mr. Chairman.

[The complete statement follows:]

TESTIMONY OF
ROBERT B. O'BRIEN, JR.
ON BEHALF OF
THE NATIONAL SAVINGS AND LOAN LEAGUE

OVERSIGHT HEARINGS ON
P.L. 96-221
HELD BY THE
COMMITTEE ON BANKING, HOUSING
AND URBAN AFFAIRS
OF THE
UNITED STATES SENATE
AUGUST 5, 1980

Mr. Chairman, members of the committee, my name is Robert O'Brien. I am President of Carteret Savings & Loan Association of Newark, New Jersey. I appear before you today as Chairman of the Government Affairs Committee of the National Savings and Loan League.

Mr. Chairman, we appreciate this opportunity to appear before the subcommittee and give our evaluation of recent actions taken by the newly created Depository Institutions Deregulation Committee. The Committee was created by Title II of P.L. 96-221, a product of months of effort by members of this committee as well as members of the House.

LEGISLATIVE HISTORY

When the final legislation emerged from the House-Senate Conference Committee last March we were quite pleased with the tone and direction of Title II. The legislation which President Carter signed on March 31 of this year provided for an "orderly phase-out" of interest rate controls over a six-year period. It vested the authority for interest rate controls with the DIDC, transferring to it the authority previously vested in each of the financial institution agencies. Both the statutory language and the Conference Report provide guidance and direction to the DIDC as to the intent of Congress regarding the six-year transition to an unregulated interest rate environment.

Section 204 of P.L. 96-221 instructs the DIDC "to provide for the orderly phase-out and the ultimate elimination of the limitations on the maximum rates of interest and dividends which may be paid on deposits and accounts as rapidly as economic conditions warrants." The section also admonishes the DIDC to use its authority "with due regard for the safety and soundness of depository institutions" and to bring interest ceilings in line with market rates "as soon as feasible, except that the Deregulation Committee shall not increase such limitations above market rates during the six-year period beginning on the date of enactment of this title." (emphasis added)

The Conference Report on H.R. 4986 furthermore clarifies the intent of Congress that the six-year term for phasing out interest rate controls was decided upon "in order to give thrift institutions time to incorporate the new powers granted to them so they may increase their earnings and be in a position to attract deposits by paying market interest rates."

The Congress, and particularly, the House and Senate Conferees obviously were aware of the fact that simply authorizing new investment powers and financial services for thrift institutions would not provide for immediate competitive parity. They recognized that it would take a period of years for thrifts to incorporate the new powers and be able to compete head-to-head with commercial banks for deposits.

Mr. Chairman, the balance struck by you and your colleagues between the legitimate interests of savers, home buyers and different types of depository institutions is commendable and does, in our opinion, provide a reasonable and sound approach to achieving an orderly adjustment in the operations of the financial market place. Unfortunately for the country, things have not worked out the way we thought you intended.

DIDC ACTIONS

On May 28, the Deregulation Committee met in public session to announce decisions which had been worked out in closed-door meetings over the previous several days. The action taken by the Committee concerned the Money Market Certificate (MMC) and the 2½-year Small Saver Certificate (SSC), the most popular and fastest growing instruments at depository institutions (in fact, it is no exaggeration to say that for most thrift institutions these two accounts have provided our only meaningful savings flows in the current uncertain inflationary period). The actions taken by the DIDC clearly violate, in our view, the legislative intent of P.L. 96-221 in at least one instance.

The DIDC voted to freeze the interest rate ceiling on the six-month MMC at 7.75 for banks and thrifts regardless of how low the Treasury bill rate might fall. Similarly they decreed that the 30-month SSC limit would hold at 9.50 and 9.25 for thrifts and banks respectively. Furthermore, the Committee substantially eroded the housing differential on the six-month account. They did so by limiting the range in which a differential might exist to 7.50-8.50% and permitting banks to roll over existing MMCs at the thrift rate.

The net effect of the arbitrary floors on what were intended to be market sensitive savings vehicles will be to hold the cost of funds and mortgage interest rates higher than market conditions would have produced. Such an action can hardly be consistent with the intent of P.L. 96-221 that savings rates be adjusted with market rates "as rapidly as economic conditions warrant...with due regard to the safety and soundness of depository institutions." Furthermore, it contradicts, in our view, the statutory language that forbids the DIDC from setting the Reg Q ceilings above market rates.

The timing of the DIDC action was certainly no accident. During the preceding weeks, we were seeing a dramatic decline in market interest rates. We were on the verge of a return to the thrift differential on money market certificates and mortgage rates were beginning to fall. On the horizon was a return to affordable mortgage rates, renewed housing construction, and an increase in the share of market sensitive deposits going to the thrift industry. The commercial banks reacted in predictable fashion. They called upon the DIDC to protect their share of MMC deposits by eliminating the one-quarter of one percent housing differential. The Committee's response was first to restrict the differential on the six-month certificate accounts to a very limited range and, second, to allow commercial banks to pay the thrift rate on renewed MMCs when the market rate was within this range. For all practical purposes, therefore, the DIDC has eliminated the housing differential on the most attractive savings instrument we have.

Thus availability of mortgage money will continue to be severely restricted. This action clearly flies in the face of the Conference Report's statement of purpose that thrifts would need a six-year time period to incorporate the new investment powers and services before they could be expected to compete with banks directly. Despite the intent of Congress and despite the fact that not a single new thrift authority had even been permitted to begin, the DIDC collapsed the Congressionally-mandated six years into an arbitrary 60 days.

The DIDC actions of May 28 were not only a blow to thrift earnings, they were a blow to the housing industry, to the millions of people whose jobs are directly tied to the housing industry, and to the potential home buyers who have been priced out of the housing market by rising interest rates.

The arbitrary floors on the MMC and SSC rates have virtually locked in mortgage rates of 11.5 or more and it is clear that most potential home buyers cannot qualify for mortgage loans at these high rates.

Mr. Chairman, savers today have become highly rate sensitive--particularly those savers who use the MMC and SSCs. To suggest that institutions can pay less than the Reg Q ceilings is to ignore the realities of the market place and the highly competitive nature of the consumer savings market. Competition will always keep MMC and SSC rates at the maximum. That is why it is imperative that if we are to have any hope of returning to affordable mortgage rates, the DIDC decision of May 28 must be reversed.

The Deregulation Committee actions are particularly puzzling in light of the public testimony of the various regulators prior to the enactment of P.L. 96-221. In hearings before this Committee, Governor Charles Partee, speaking for the Federal Reserve, said that while the elimination of controls on interest rates was desirable "this process must be a gradual one." He was also concerned that during the transition period "even with broadened asset powers, portfolio returns at thrifts might not rise as rapidly as deposit costs... Prudence could suggest delaying an increase in ceiling rates... to give portfolio returns a chance to catch up to deposit costs." Furthermore, Governor Partee stated that the Fed opposed the inclusion of the MMC and other variable deposit instruments in any rate increase schedule because having MMC ceilings above Treasury rates would be "tantamount to removing ceilings on these deposits and ignoring the problems of the transition period...". This testimony, given in June 1979, bears little resemblance to the policies advanced by Chairman Volcker in the Deregulation Committee.

Other DIDC members have expressed similar views. At the same hearings Mr. Cantwell Muckenfuss on behalf of the Office of the Comptroller said that "elimination of these ceilings must be accomplished gradually to allow thrift institutions sufficient time to implement their new powers and to make other necessary changes in their operating and portfolio policies."

Mr. John Heimann, in a hearing on equity for the small saver had this to say about phasing out Reg Q:

> "Removal of deposit rate ceilings in the present economic environment would have catastrophic consequences, not only for the thrift industry and some banks but also for the home-building industry and perhaps other sectors of the economy. Despite the inefficiences that result from Regulation Q, the inefficiences stemming from its removal, at least in the short run, might be much greater. Therefore, any solution to the problem must of necessity involve a gradual phasing in over time."

There are other examples, Mr. Chairman. The public record behind P.L. 96-221 is filled with assurances from the various regulators of their concern for an orderly and gradual adjustment period for the protection of the housing industry and thrift institutions.

Beyond the frontal attack waged by the DIDC on the housing differential, the committee's action has virtually guaranteed that mortgage money will remain limited and prohibitively expensive for the foreseeable future and that housing will remain in a state of depression. This later point is by far the most important and one which calls for quick remedial action by the Congress. If the DIDC actions of May 28 are not reversed, 1980 will see the worst housing depression since the 1930s, with ripple effects of unemployment spreading to other sectors of the economy.

The actions of the DIDC can hardly be viewed as consistent with the "safety and soundness" language of section 204. For several months prior to May 28 thrift institutions experienced unprecedented increases in their cost of funds as a direct result of rising interest rates induced by the Federal Reserve. The earnings position of the industry was getting steadily worse. For the first time the industry as a whole had negative earnings the second quarter of this year. On May 28th the members of the DIDC knew full well the condition of the thrift industry. They also knew that declining costs of funds offered the only real solution to the problem. The decline in market interest rates occurring at that time and the anticipated return of the thrift differential on MMCs offered real hope of revival of the thrift and the housing industry--a return to affordable mortgages and profitability in our industry.

Because of the DIDC actions the savings and loan industry will continue to show negative earnings this quarter. Savings and loan mortgage lending is 60% lower than a year ago. We saw withdrawals exceed new savings by $250 million in June, the first month under the new anti-housing DIDC policy. Current estimates indicate, overall, a negative spread between the cost of funds and portfolios yield. What all of this adds up to is that 1980 will almost certainly be the industry's worst earnings year ever.

I want to emphasize, Mr. Chairman, that the profitability of the thrift industry is much more important than the personal interest of those of us who work in the industry. Public confidence in our institutions is crucial to our nation's economic well being. Public confidence, which has been gradually restored since the 1930s, is the foundation of our financial system. That foundation can be seriously eroded with severe consequences for the whole system if a major component of that system is kept in a weakened position for an extended period of time.

HOUSING NEEDS IN THE 1980s

The predictable age distribution pattern, family formation rate and other demographic estimates plus estimates of expected losses in the housing stock, suggest that we need to build 2.2 million housing units a year in the 1980s. This forecast, along with the DIDC actions, asks a critical question--Is housing still a national priority? That question can only be definatively answered by the Congress. If the Congress will act to reverse the May 28 decision and give clear directives to the DIDC, it will be giving an affirmative answer. If the Congress does nothing, it is saying that despite the unprecedented housing demand ahead, housing has no particular position of priority as a national goal.

CONCLUSION

Mr. Chairman, in light of what the DIDC has done in spite of statutory language and legislative history, I wish to summarize for this committee the comments and suggestions we made on January 30 when we testified on H.R. 4986 before the financial institutions subcommittee in the house. We said at that time that the adjustment to an interest rate free market would be far more difficult for thrift institutions than for commercial banks because of the predominantly fixed rate long-term nature of thrift asset portfolios. We said then and ask again that the Chairman of the Federal Home Loan Bank be given an equal voice with the commercial bank regulators. This can most effectively be accomplished by requiring that the DIDC actions be made by unanimous decision of its members.

Another point we made last January is that due to the unprecedented demand for housing construction in the decade of the eighties, there should be a housing differential on all forms of savings accounts. Given the current prediction that housing starts may be below one million units this year and the apparent inclination of the DIDC to keep mortgage credit restricted and housing depressed, the need for a mandated housing differential is all the more urgent. The housing differential should apply to all savings accounts and to all depository institutions that have a substantial percentage of their assets invested in residential mortgages.

In conclusion, Mr. Chairman, we are here today to plead the case of housing and the continued opportunity for American families to own their own homes. We respectfully ask this Committee and the Congress to amend Title II of P.L. 96-221 to clarify the intent of Congress and clearly state the priority the Congress places on housing.

Specifically, we urge the Congress to direct the DIDC to (1) maintain an interest rate differential on all savings accounts covered by Regulation Q, (2) define market rate for Title II purposes as Treasury bill rates of comparable maturities, (3) prohibit the DIDC from creating artificial minimum ceilings on instruments designed to fluctuate with the market, and (4) make all Regulation Q adjustment decisions by unanimous vote. In doing so the Congress would not be breaking new ground or reversing any prior legislative acts. It would, rather, be clarifying its intent and ensuring that the mandate for an orderly and gradual six-year phase-out of interest rates will be honored by the DIDC.

EARLY WITHDRAWAL PENALTY

As to the DIDC decision on withdrawal penalties, Mr. Chairman, it is important to keep in mind that the viability of the mortgage market is enhanced by stabilizing deposits as much as possible. For this reason we have supported a strengthening of early withdrawal penalties. However, many of us feel that the DIDC went too far when they set in place the possibility of an invasion of principal. Had the DIDC followed the common practice of allowing a comment period on their proposal, they probably could have developed a more acceptable plan which would have accomplished the very worthwhile objective they sought--namely, stabilizing deposits.

Mr. Chairman, members of the committee, on behalf of the National Savings and Loan League, thank you for holding this hearing and affording us this opportunity to present our views. I look forward to your questions.

ADDENDUM

Testimony of Financial Institutions Regulators
Regarding Phase-Out of Regulation Q

Excerpts from Equity for the Small Saver, Hearings before the Subcommittee on Financial Institutions, United States Senate Committee on Banking, Housing and Urban Affairs, April 11 and 12, 1979

John G. Heimann, Comptroller of the Currency,
April 11, 1979 (page 54):

> "Removal of deposit rate ceilings in the present economic environment would have catastrophic consequences, not only for the thrift industry and some banks but also for the homebuilding industry and perhaps other sectors of the economy. Despite the inefficiencies that result from Regulation Q, the inefficiencies stemming from its removal, at least in the short run, might be much greater. Therefore, any solution to the problem must of necessity involve a gradual phasing in over time."

J. Charles Partee, Member, Board of Governors
of the Federal Reserve System, April 11, 1979
(page 59):

> "Before discussing these proposals and the two resolutions in detail, I believe it appropriate to review briefly the institutional, economic, and legislative constraints that impinge on regulatory decisions concerning deposit rate ceilings. Although market developments are rapidly undermining the efficacy of these ceilings, many of the factors that initially led Congress to establish this regulatory framework are still at work. A review of these constraints is therefore necessary to an understanding of the regulatory decisions that are currently at issue.
>
> "The fundamental constraint is that thrift institutions still cannot pay market-oriented rates of return on all their deposit liabilities during periods of high interest rates. Their inability to do so results from restrictions which limit their investments principally to long-term, fixed-rate mortgages. Because of slow turnover in these mortgage portfolios, the average yield on thrift assets responds sluggishly to changes in market conditions. For example, average returns on mortgage portfolios have risen only 2-1/2 percentage points since 1966, when deposit

rate controls first were introduced, while inflation-induced increases in short- and intermediate-term market interest rates have averaged 3-1/2 to 4 percentage points over the same period. As a result, the earnings of thrift institutions are still squeezed whenever they try to compete for funds by paying market rates during periods of credit stringency. Before thrifts can be expected to pay market rates on all their deposits, reform of their asset powers will be necessary. Otherwise, the financial solvency and stability of many individual institutions may be jeopardized.

"It should be emphasized that commercial bank earnings have never been a limiting factor in the regulatory decisions on deposit rate ceilings. Banks hold a more diversified portfolio of assets whose maturities are, on average, considerably shorter than those of the thrifts. The rates of return on commercial bank portfolios have thus been more responsive to market yields and have given them greater flexibility to pay competitive rates on deposits."

Excerpts from Depository Institutions Deregulation Act of 1979, Hearings before the Subcommittee on Financial Institutions, United States Senate Committee on Banking, Housing and Urban Affairs, June 27, 1979

J. Charles Partee, Member, Board of Governors of the Federal Reserve System (pages 66 and 67):

"The Board has long advocated the gradual removal of deposit interest rate ceilings. Most economists believe that these ceilings are anti-competitive—and that they have a particularly inequitable impact on the small saver. Moreover, by reducing depository institutions' ability to compete for funds, ceilings subject such institutions to significant periods of disintermediation whenever market interest rates are cyclically high. However, while the elimination of deposit rate ceilings is by itself highly desirable, this process must be a gradual one. Many of the factors that caused Congress to establish the framework for coordinated rate ceilings in 1966 are still at work. Thrift institutions, because of constraints on the kinds of assets they hold, still are unable to pay market-oriented rates of return on all deposit liabilities when those rates are high. Before the thrifts can compete in such an environment—without jeopardizing the financial solvency and stability of individual institutions—reform of thrift asset powers is necessary."

"First, while the Board strongly supports the phasing out of deposit rate ceilings, we believe that the regulatory agencies should be able to respond flexibly to circumstances created by the transition to a ceiling-free environment. For example, it is conceivable that, even with the broadened asset powers, portfolio returns at thrifts might not rise as rapidly as deposit costs—leading to serious earnings squeezes at a sizable number of individual institutions. Prudence could suggest delaying an increase in ceiling rates at one or more points in the transition period to give portfolio returns a chance to catch up to deposit costs."

"A second concern we have is that the scheduled increases in ceiling rates appear to apply to money market certificates and to the new savings certificate with a variable rate ceiling tied to the yield on 4-year Government securities. These instruments are broadly designed to key permissible deposit rates of return to the market and the Board sees no reason for including them under the proposed legislation. Indeed, under the scheduled phaseout, ceilings on MMC's would quickly rise above the rates on corresponding Treasury instruments—which is tantamount to removing ceilings on these deposits and ignoring the problems of the transition period which otherwise have been so carefully addressed in the bill."

Cantwell F. Muckenfuss III, Senior Deputy
Comptroller of the Currency for Policy,
Office of the Comptroller of the Currency
(page 109):

"Diversification of thrift powers and preemption of state usury laws will improve thrifts' earnings flexibility and enhance their ability to provide one-stop banking services. These changes are essential elements of the overall program of deregulation and elimination of deposit-rate ceilings. However, elimination of these ceilings must be accomplished gradually to allow thrift institutions sufficient time to implement their new powers and to make other necessary changes in their operating and portfolio policies."

Excerpts from Regulation Q and Related Measures, Hearings before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance, House of Representatives Committee on Banking, Finance and Urban Affairs, January 24, 29, 30, 31; February 5, 20 and 21, 1980

Robert Carswell, Deputy Secretary of the
Treasury, January 3, 1980 (page 183):

"The important thing is to have a predictable and settled scheduled phase-out known to all parties—regulators, institutions and household customers—well in advance of each incremental change."

John G. Heimann, Comptroller of the Currency,
February 20, 1980 (pages 810-811):

> "It is urgent that we begin an orderly process of financial institutions reform. The piecemeal easing of Regulation Q by the regulatory agencies in response to the prospect of disintermediation must be matched by an accompanying liberalization of thrift powers to address the thrift earnings problem. Thrift institutions need authority to begin the process of adapting their services in response to the more competitive marketplace.
>
> "In fact, this process of adaptation should have begun long ago, when market interest rates were closer to the ceiling rates and competitive pressures from non-depository institutions were less intense. As we noted in our testimony before this Committee last year, it will take time for thrift institutions to implement new asset and liability powers and to make necessary adjustments in their portfolio and operating policies. Those commercial banks dependent upon retail deposits will also need the opportunity to adjust the services they offer. For these reasons, we supported a gradual phaseout of deposit interest rate ceilings."

J. Charles Partee, Member, Board of Governors
of the Federal Reserve System, February 20,
1980 (pages 831 and 832):

> "Allowing the thrift institutions to earn more market-oriented rates of return on their portfolios by widening their asset powers will help provide the additional earnings flexibility needed to allow them to pay market rates of return on an increasing portion of their deposit liabilities. But the Board believes that the phaseout of deposit rate ceilings must be gradual so as not to threaten unduly the viability of the institutions."
>
> "In addition, the Board believes that money market certificates and the longer term variable-ceiling certificates should be exempt from mandatory ceiling rate increases until the end of the phaseout period. These deposit instruments already are designed to provide returns that will vary with market conditions, and that yield very close to what can be obtained on market securities of comparable quality. Increasing these ceilings on any fixed schedule would quickly eliminate binding restrictions on such deposit rates and could lead to earnings problems arising from competition between types of depository institutions during the transition period. Similar exemptions should, of course, apply to any other variable-ceiling instruments that float with the market introduced during the phaseout period."

The **Chairman**. Thank you, Mr. O'Brien. Mr. O'Brien, could I get your views on the proposed ban on premiums, the proposed ban on finders' fees, and that we establish early withdrawal penalties—first, should the DIDC adopt the proposed ban on premiums?

Mr. **O'Brien**. In my personal view, no. The national league does not have an official position on this, because we are geographically dispersed. Some like it and some don't. But I come from Newark, N.J., which is the heart of the metro area premium bonanza that Mr. Klaman talked about. I can tell you from my own personal experience with my institution that we are still profitable for 1980, and the reason is we have been giving away premiums.

That has given us a $70 million inflow. That has given us the availability to lend those funds back into the housing market. And therefore, we are showing a profit, so it works for us.

ABOLISH FINDERS' FEES

Finders' fees, I think I agree, that's a separate and distinct case. It's a violation. I personally would urge that they be abolished, but not premiums as we know them.

The **Chairman**. In your view, is the early withdrawal penalty too harsh? Should it be changed so that it does not eat into the principal?

Mr. **O'Brien**. Over time, I would say yes. I must confess that I tend to agree with Chairman Volcker's position on that.

But on the other hand, the savings public has not yet regarded a savings institution as a place to get market rates of return, although that's happening.

The **Chairman**. They also haven't regarded it as an institution that doesn't give them back their principal.

Mr. **O'Brien**. That is true. That is why I say it's too early to implement that, in my opinion.

The **Chairman**. Mr. Gunderson, I'd like to have your views on those points. First, the ban on premiums.

Mr. **Gunderson**. We're opposed to the committee's proposal on the ban on premiums. We think that premiums have a place in the marketplace, if a financial institution wants to offer them to attract deposits. It's our ultimate hope that we may reach a point in time where the interest rates will be the attractive feature. Once we get through the deregulation process, maybe premiums won't be necessary then. It will be the rates you pay on your funds.

The **Chairman**. What about finders' fees?

Mr. **Gunderson**. I'm not as well prepared to respond. I think we feel that somewhere in that same area, properly controlled, that finders' fees, if used properly—we don't have a formal position on the penalty.

Our people are looking at that. We'll be glad to furnish that.

The **Chairman**. On the withdrawal penalty?

Mr. **Gunderson**. On the withdrawal penalty—we're looking at that. When we look at it, we'll be glad to furnish our opinions at that time.

The **Chairman**. I'd like to give you and Mr. Hutchinson both a comment on the next question.

Deposit data for June suggests that there has not been—I guess I also ought to ask Mr. Miller to comment on this, too: there has not been a significant shift in market share between commercial banks and thrift institutions, because of the changes made in interest rate differential and in money market, small savers' certificate ceilings, or from the regulation allowing commercial banks to roll over money market certificates at the thift rate.

However, during June and July, money market mutual funds continue to grow at the rate of $1 to $1½ billion a week. It would appear, therefore, that on the basis of the information we have, the threat is not from members of the banking community but from the marketplace. What's your comment?

Mr. GUNDERSON. Mr. Chairman, I couldn't agree with you more. I don't think the enemy is each other. And I think we're just seeing the tip of the iceberg in this particular type of area, because we're going to see retail organizations expand into it, further expansion all the way. This is where our problem is—not in a differential between what the thrifts will pay and what we can pay. We think we should do away with the differential.

NEED DIFFERENTIAL TO ATTRACT FUNDS

Mr. MILLER. I would tend to disagree. I believe that we need the differential to attract funds, even in light of the effect of the money market mutual funds. I think especially smaller savings and loans still need that differential to attract funds for housing in the inner city communities.

The CHAIRMAN. How do you account for the fact that in spite of the lack of differential, the outflow has not been from S. & L.'s to banks, but from S. & L.'s to mutual funds?

Mr. MILLER. I don't think that would be true for the smaller S. & L.'s. I think if you look at the statistics, you'll find there'd be a vast difference. We've had a net effect of zero as far as savings for the last 3 months.

The CHAIRMAN. Do you have any statistics on the difference between the small S. & L.'s and the large ones?

Mr. MILLER. No, I do not. I cannot speak on that particularly. I can speak primarily from my institutions and other institutions in the State of Virginia which I am in close contact with. Our savings flows have slowed down to practically zero in the last few months.

The CHAIRMAN. Mr. Hutchinson.

Mr. HUTCHINSON. I think the fact that the NCUA has allowed credit unions to have a 9½-percent rate on their certificates has been a deterrent to some outflow. I would have to agree with the chairman, however. The culprit here is the money market funds.

Interesting to note, that the credit unions haven't been in the position to pay the higher rate on their savings dollars for many years and did suffer great outflows. In view of the fact that we have had that differential in our favor, it did not seem to be a major factor in stopping the outflow when the money market funds started to pay the yield. In our opinion, it seems that the marketplace seemed to dictate a need, and that need was filled by the money market funds. And that is the real problem, I think, that we have.

The CHAIRMAN. Could I ask Mr. Brooks to comment on that, because I don't think I have gotten, and I should get, a comment from the U.S. League.

Mr. **Brooks**. Yes, sir. Is this—which is that? The premiums or withdrawals?

The **Chairman**. No, this is on the fact that we have not had an outflow of funds from the S. & L.'s to the banks under these circumstances in June and July. We have had an outflow to the mutual funds.

Mr. **Brooks**. Mr. Chairman, the problem, as we see it, is the matter of the differential between the banks and the S. & L.'s.

The **Chairman**. That may be the problem, but why isn't that reflected in any of the statistics?

Mr. **Brooks**. Part of the problem—or part of the statistics—and I haven't gone into Mr. Volcker's table 3 he had this morning—but it appears that he used there the credit of interest during this period of time, which was substantial. For example, as I recall, credit of interest was somewhere close to $6 billion. We actually ended up with 0.22, about a quarter of a billion dollars, or, say, $220 million, in the red for the month of June.

To show you what the differential meant in May, bear in mind in March and April we went in the red with savings. In May, when we got the differential back, when the money market certificates dropped below 9 percent, the business went in the black by $1.8 billion.

The **Chairman**. May I just interrupt. The problem is, Mr. Brooks, that in those months you had the same problems with the banks. The banks and savings and loans had almost exactly the same problem, going into the red in April and May.

Mr. **Brooks**. We didn't go in the red in May, sir. When we got the differential back in May, we were up $1.8 billion. When we lost the differential, we were in the red.

The **Chairman**. Six-month money market certificates went in the red for thrifts minus $5.6 billion in May.

Mr. **Brooks**. Yes, we were both losing on the money market certificates. There is no doubt about that. But if we'd had the differential, it is estimated that we would have gotten in the next 6 months, $17 billion, which would have gone into housing.

The **Chairman**. Statistics indicate it may be as you say. It may not be. I think maybe we should try and get more time before we make a judgment on it. But it would appear the differential made no difference at all as far as the commercial banks and thrifts are concerned. In fact, the banks seemed to have been hurt a little bit more.

Mr. **Brooks**. Those statistics, I think, have the interest credit. We went in the hole by $4.4 billion on money market certificates. We picked up $7.4 billion in 2½ year CD's. We have ended up 1.8 up in May. But we were down to 0.22 in June. We went down 4.6 on the money markets, but we picked up 4.7 in the 2½ year.

The point is we didn't get the money back. We haven't gotten it back. We can't do the lending.

The **Chairman**. I understand that. My only point is that the market share didn't change between the two kinds of institutions. So the problem seems to be the higher rate paid by the certificates—mutual funds, rather than the fact that the differential has been removed.

Mr. Brooks. That has not been a problem as far as we're concerned. We would lose some money to the money market funds, but the problem is the differential.

The Chairman. Would you do this, for the committee: Could you take a look at this and give us statistical evidence supporting your position?

Mr. Brooks. Yes, sir.

The Chairman. I realize it's very difficult to do that off the top of your head. But if you could do that, we would appreciate it.

Mr. Brooks. I would be most happy to do that.

STATISTICS COULD BE MISLEADING

Mr. Klaman. I think the statistics can be very misleading and confusing. I would like to put in two points of principle: Our major objection—apart from what the data may say, the jury is still out on that—but the point is why did DIDC act so precipitously in taking this action after months and months of permitting the differential not to be in effect and after implicit commitments that the differential would be back in when rates fell below 9 percent? The moment that happened, they acted. It's the principle; it's the philosophy; it's the thinking behind the action that I think should concern this committee.

The statistics are going to confuse us all, but that is the action that was taken almost instantaneously after 13 months of misery and then waiting for the rate to fall. Before they had a chance to see what the action would result in, they took action.

Second, the money market funds are clearly the problem. Why does not this Senate Banking Committee propose legislation which will equalize the ballgame? The reason money market funds are doing so well is one reason, but that psychologically they hold out to the saver the opportunity to get his hands on his money instantly. Reserves are going to be universally applied to deposit institutions' transaction account. Why aren't they universally applied to all transaction accounts, including money market funds? If they want to stop the checkwriting capability, fine; no reserves. But there's $90 billion there leaking out of the money market supply. How can the Senate Banking Committee ignore that?

Let's admit the money market funds are the culprit. So why do you just ignore it and let them go on being the culprit? We're not asking for unusual regulations; we're asking—to use the terms of my friends in the ABA—a level playing field. Let's have reserves against transaction accounts wherever they occur, and let's examine the principle to go back to the DIDC, let's examine the principle of why did the committee act so precipitously? What was behind it? Was it the fact that they were concerned or that they were worried about the small banks? That's the real issue here, not whether the action precipitated outflows from thrift institutions beyond what they otherwise would have. Why did they do that?

The Chairman. You're asking for something that we have not had experience with.

My time is up, but let me just finish this.

The Fed says that the properties of the money market funds are not the same as the deposit accounts, that the average money market fund is $8,000, quite different than the average deposit in an S. & L. commercial bank, and they don't have the properties, the transaction account properties that the deposit accounts have in the commercial banks and S. & L.'s. Maybe that's wrong; maybe we ought to take another look at it. But that seems to be the position taken by the Chairman of the Federal Reserve.

Mr. KLAMAN. I think he would be receptive to some discussion on this issue.

The CHAIRMAN. I think he should be. That's right. My time is up.

And, Senator Morgan, I have a meeting in my office for a few minutes. You take over the committee, and I will be back in 10 or 15 minutes.

Senator MORGAN [presiding]. Thank you, Mr. Chairman.

Gentlemen, the first thing I should say is I think it's unfortunate that we've had such a distinguished and knowledgeable panel of people before us on a day like this, when we've had so many votes. I am not sure that I even know what has been said.

But, Mr. Klaman, with regard to your question, that's what I hoped to hear from Mr. Volcker this morning, and one of the questions I wanted to pursue with him, but we just had such a turmoil I couldn't get to him.

As I understand it, I can deposit $10,000 at Merrill Lynch and write checks on that immediately. Is that your understanding?

Mr. KLAMAN. A minimum of $500.

Senator MORGAN. Is there any reason why the Fed, in your opinion, could not require some reserve requirements?

Mr. KLAMAN. The legalities, I believe, Senator Morgan, I would leave to the committee and the attorneys.

Senator MORGAN. I understand the law.

Mr. KLAMAN. But I think that, from my own discussions with the Chairman and some members of the Board, this is not an issue which has escaped him, clearly, and I don't think he would be unreceptive to any suggestion or proposal by the Senate on this issue. He is deeply concerned about $90 billion escaping the money supply. It's a vexing problem, but I think, initially, with this committee he would be responsive.

Mr. HUTCHINSON. Senator, could I just comment briefly to that?

Senator MORGAN. Yes.

DEREGULATE FINANCIAL INSTITUTIONS

Mr. HUTCHINSON. I have been in the credit union world now for 35 years, and I was amazed to see a new kid on the block in 6 months' time accumulate as much money as credit unions took 35 years to accumulate. That tells me something. What that tells me is this: Maybe, instead of considering regulating the money market funds, we should give more consideration to deregulating the financial institutions to make the marketplace more even. If that new kid on the block can do it, why can't we do it?

Senator MORGAN. Let me come back in just a minute to your question and ask you what you mean by "deregulating the financial institutions."

But let me go to Mr. Gunderson and say, has the ABA discussed or talked about the possibility or advisability of legislation that would require reserve requirements on transactional accounts on these money market funds?

Mr. Gunderson. Yes, Senator. We have been on record in favor of some sort of reserve requirement on the money market mutual funds. We think the problem goes beyond that. We would hope that, ultimately, we would be in a position where we could compete on an equitable basis with the money market funds. But certainly, on a temporary basis, I agree. As long as they're offering a transaction-type account, we can be very supportive. We supported the Fed when they put the reserves on during the credit restraints. We were disappointed to see the reserves come off.

Senator Morgan. Do you think they had the right to put them on during the credit restraint period?

Mr. Gunderson. I am not sure about all the legal technicalities of it, Senator. We were certainly all for them.

Senator Morgan. I was, too. I questioned in my own mind if they could then, if they could not now.

Let me come back, because there is a number of things I want to ask, and then, time permitting, I will get back to you on deregulation.

Mr. O'Brien, you say in your statement that the DIDC collapsed the congressionally mandated 6 years into an arbitrary 60 days. That being true, and that being your position, what would be your position on the bill that a number of us introduced in which we spell out the phaseout of regulation Q, so to speak?

Mr. O'Brien. Well, Senator, we are polling our membership on this, because our executive committee was split on it. I think that it's the old argument of certainty versus uncertainty and control. And I think my personal view is that I think there is a great deal of merit to your bill, but if the DIDC could be sent the appropriate message—and I think maybe this morning they got a little of that—that we could live with them.

Senator Morgan. Let me just say in response to that that I am not sure you can send them an appropriate message.

Mr. O'Brien. If we can't, then I certainly support the bill.

Senator Morgan. My position has been well known since the day I came to the Senate, that I value all of our financial institutions. I think the savings and loan and thrift institutions have made some great contributions to America. I don't see—it seems to me that the banks have done well under the system that we've had. I don't see the urgency of eliminating it.

But, nevertheless, I have fought that now for 6 years, and the Congress has said, "Well, phase it out." And no man, Volcker or anybody else, could read the debates on the floor of the Senate, read the reports, and in good faith, in good conscience, in my opinion, say that it was not the intent of this Congress to phase it out gradually. I think it's just the arrogance of power.

If I thought we could, I would prefer to see some flexibility in the event of emergencies, but I think Mr. Volcker is a good man. He and I have a good relationship. Because prior to the time he became Chairman of the Fed he was against reserve requirements for the States. Then he came around and tried to convince me otherwise. I was always asking him when does he want me to believe him, you know. He's a strong-willed man.

Mr. Brooks, in my bill this morning, in the bill that I introduced, do you recall that the maximum rate shall be not less than one-quarter percent until June 30, 1981; and it comes down to zero? I follow what Mr. Janis said this morning. But it seems to me there is no real harm in striking out the words "not less than." It's just a hard, clear fact that this is the way it's going to be.

Do you see anything wrong with that?

Mr. BROOKS. Senator, the only objection I would see to striking it out would be the fact that housing is in such a state and with the pent-up demand in this country—and I am sure you've seen some of the articles around the country about what the housing situation is and probably will be—that we may be in a position that we would need more than a quarter point differential.

I recall back in about the 1970's when we lost half of the differential down to a quarter. It may have just been a conincidence, but housing starts plummeted. We went from one-half to one-quarter. I would prefer to see that left in there. We would like to see, very frankly, the differential preserved, for the reason Mr. Janis had mentioned this morning. You remember, he mentioned the two-valve type thing.

I would like to add that is one valve on the asset side, where our earnings would start coming through to match the liability side, where we would be paying market rates. It's going to be at least 3 years before we get any trickling through that pipe from that valve at all, and it's going to take longer than that before it becomes significant. And that's our concern, why we feel that the original intent of H.R. 4986, the differential—I know it doesn't say that, but by implication—be preserved or, at the very least, that with your bill, that at least a year would go by where this report called for in H.R. 4986 as to whether the reducing or the dropping of the differential would hurt the viability of thrift institutions at that point in time, because we have been through, as we all know, a devastating period in earnings of the savings and loan business in this country, that we and Congress take another look at it 1 year from now as to whether or not it should be phased out.

Senator MORGAN. Of course, you understand I wasn't for either one of the valves. But I lost, so I have got to accept that fact.

Mr. BROOKS. Let me say this, Senator. We applaud you and Senators Garn and Riegle for recognizing that we've had a real problem here as far as housing is concerned, and that the DIDC did move too rapidly.

Senator MORGAN. Well, we recognize that. But the point I want to try to make is I think the Congress has spoken on the differential. I think we have got to accept that verdict and say, "Well, all right, the Congress has spoken. Let's try to carry out the intent of Congress." And I think I know what it was, because I was there every day. So isn't it unrealistic to think that this committee or anyone else would ever go beyond these percentages? In other words, it's nice to have them in there in case of an emergency, but it seems to me it's very unrealistic to predict that anybody would go above it?

Mr. BROOKS. To go above the quarter percent? Perhaps it would be. At the very least, the quarter-percent differential—and this is our position—we would like to see it preserved, for the reason I mentioned, over the full 5-year period.

Senator MORGAN. I know you would. But I don't believe that, given the realities of the situation, I don't believe we would expect the full quarter percent more than a year. That's what I had in my bill.

Mr. BROOKS. Yes, sir, I know you did.

Senator MORGAN. So what I am saying is that this is not what I like, but this is what I think is practical.

Mr. BROOKS. Is it feasible that the year delay be made and then come back to Congress to consider your plan at the end of the year?

SERVICES NOT GOING TO BE PROFITABLE

Senator MORGAN. I agree with you that these new services that we gave you are not going to be profitable in 1 year or 2 years or 3 years. As a matter of fact, they aren't going to be profitable until we come back probably next year and say, "All right, you can have your assets and so forth, eventually, all the services of banks."

What did the prior Secretary of the Treasury say, Mr. Blumenthal? I asked him a question three times when he was testifying on the reason for the bill: What would be the difference between the thrift institutions and the commercial banks? He couldn't enumerate any, and just said, "Well, the differences will be much narrower." And each time, he puts it a little stronger.

That's something we're going to have to live with if the situation gets any worse.

Mr. BROOKS. If we could, in that year's time, a lot of things will happen.

One, of course, is—in my own instance, I'm rolling off a lot of those 5½ and 6 percent loans you talked about this morning.

Point two, our projections show that this business should be in the black, say, by the end of this year, by the fourth quarter.

So, the situation may improve. I just have a concern of setting in concrete the drop of the five basis points per year.

Let me ask you this: Would it be possible, in addition, in your bill that we define market rates? Also, that this lower ceiling idea, which holds us, all up at one point, and maybe also have the veto power 60 days in either House of Congress of the action of the DIDC relative to rates?

Senator MORGAN. I think that market rates are something that we ought address.

I had a pretty bad letter from a banker back home about my bill. He really said I had sold out. You know, some people can't write you without accusing you of being corrupt and dishonest. I sometimes think they judge everybody else by their own standards. But he told me how great his percentage of housing was.

Mr. Gunderson, what is the average percentage of commercial banks' investment in housing?

Mr. GUNDERSON. Senator, if you'll excuse me just a moment, I'm getting out some numbers here.

In residential mortgage loans outstanding in the fourth quarter of 1979, banking had about $158 billion, which represented about 15.8 percent of that particular category.

Our involvement in real estate lending goes far beyond that though. We're into—our mortgage companies, of course, are not reflected in here—you know, all the sales there, the secondary market involvement. We're the leading lender in mobile homes, which has become a fast-growing area for the young family.

Senator **Morgan**. Mobile homes are handled more like consumer loans. The interest rate is generally much, much higher, is it not?

Mr. **Gunderson**. Of course, the cost of them is getting larger, and you're spreading them out. They used to give them for 5 or 6 years. And now they're out 10 to 12 years, so they're really becoming long-term lending. And the rates vary with the institution.

Senator **Morgan**. I think that if my recollection serves me correctly, that since about the fifties the rate and percentage of commercial bank money going into, say, up to a four-bedroom home has declined from something like 22 to 23 percent down to 21 percent. It's not much of a decline, but it's not an increase. Whereas, the thrift institution has gone from about a 30 up to about a 55 percent—but I'm not sure commercial banks should. You've got to have business loans, you've got to have your mobile homes.

Mr. **Gunderson**. Well, Senator, banking's role in housing though is expanding. I think one of the key areas was the removal of the usury limitations, because you could then develop a market-attractive instrument that you could sell into the secondary market.

We're developing passthrough programs, putting together—hopefully in time, we'll be able to put together pools of mortgages, self certificates in them.

I think there are a great many opportunities that we're expanding into. And I think we also need to keep in mind all the housing-support financing that banking is involved in.

Senator **Morgan**. Well, Mr. Gunderson, let me just sound a note of warning. I doubt very much that you're going to find the usury rates indefinitely suspended in this country. I don't know how a person can ever pay for a home at 15, 18, even 12 percent, let alone 15 and 18 percent.

Now, we've got another vote. And I want to ask one question of all of you—but, Mr. Hutchison, you mentioned it. What do you think the role of regulatory agencies should be with financial institutions? Is it to control every move of your bank? Or is it to preserve the solvency of the banking institution for protection of the depositors?

Mr. **Hutchison**. Senator, I don't want to leave the impression that I want you to think that I believe that we can live in a completely unregulated society. I don't think that's possible. I think it's necessary to have controls. I think there have been many things done that have been done for the good of the Nation in regard to our fiscal policies.

What I am speaking directly to is the fact that the rates in financial institutions have been so strictly controlled, whereas they are not in other areas of the economy. That's the point I'm trying to make.

The question in my mind is why just financial institutions? Why are they singled out and told "You must have controls placed upon you as far as the rates that you pay to attract funds"?

SAVERS GET SHORT END

There are two types of people investing in funds, those that are the investors and those that are the savers. I think those that have been the savers have gotten the short end of the stick, because we were limited as to the maximum we could pay them on the money they've put in that, plus the fact of the devaluation of dollar value.

The investors, of course, go in with a known risk for higher yield or the fact that they can have a loss in the principal.

There's no way that any savings institution, whatever it is, should be forced to cause a person who puts their funds in that savings institution to lose any part of the principal.

I know I'm going rather generally in the discussion. But the point I'm trying to make is: why regulate just the financial institutions on the rate structure?

It seems to me that if the rate structure is allowed to flow in the marketplace, if the new kid on the block can do something with it, we certainly can. Certainly bankers, with all of their experience, could do that.

Senator MORGAN. Let me hear from Mr. Brooks for just a minute before I have to leave.

Mr. BROOKS. Senator Morgan, I'll be brief.

Your question was on the thrift institutions' role. I understand that the thrift institutions—and this includes the savings and loans, of course, and the Federal Home Loan Bank system was created to provide a safe place for savings and to provide home financing for all Americans.

I think that in the case of the Home Loan Bank Board, that it's been doing a good job for this. It really doesn't matter about the savings and loan association. Look what's happening in housing. We've had a national priority of housing in this country, but if the national priority and the American dream of home ownership is going to be changed, I think the American people should have a right to debate that and to make the decision, not five men, as on the DIDC.

Senator MORGAN. Well, I've got to go. And I doubt I'll be back.

But one of the things that has been bothering me for a long time—and, Mr. Gunderson, sometime I'd like to see what the ABA—I realize that the role of a regulatory agency—you've got to protect the savers, because you do have a monopoly of a sort. You've got to make sure that the public is served.

But it seems like, to me, within those broad areas, that the institution, being a part of the private sector, ought to have some leeway as to how you conduct your business.

In the 6 years that I've sat here, it seems to me that almost everything I've seen has been coming down to the point where the regulatory agencies are trying to make every little minute decision for the institutions.

It goes back, you know, before the airline deregulation. I fly on airlines all the time, as I'm sure you do. And it seems to me that if I'm a customer of Eastern Airlines, from here to Raleigh and back, that Eastern Airlines ought to be at least able—if they're willing to, to be a little nicer to me than maybe somebody else in order to keep me from flying some other airline.

But no, they got to the point where they could hardly say "Good morning" to you and call you by name, because that would be showing partiality.

I was amazed when I went home to borrow some money for my old business. My goodness, the forms that you have to fill out have changed so much in the 12 years that I quit practicing law. It's ridiculous. And if we're going to keep on doing it, we might as well turn the banks over to the Government to save money.

I guess we'd better recess. The Chairman will be back in just a minute. I've got to go vote. [Recess.]

The CHAIRMAN. The committee will come to order.

Mr. Klaman, in your testimony, you strongly object to the establishment of minimum ceilings on 6- and 30-month certificates. The DIDC was clearly mandated to provide for the orderly phaseout. This appeared to be a first step to allowing market forces to come into play.

On what basis do you assume that market forces will not allow rates to decline below the ceiling?

You mentioned the pressure on earnings that will result. You seem to argue that indeed competition will force rates to decline below minimum ceilings if yields on Treasury bills drop to below 5 percent.

PRECIPITOUS ACTION ON DIFFERENTIAL

Mr. KLAMAN. First of all, I'd like to have it clearly understood that our strongest objection is to the precipitous action on the differential.

The minimum ceilings—I think our feeling was clear that if there's a mandate—and we thought, in all of the conversations we had, you're talking about market-related rates—why are they related only on the upside and not on the downside?

Apart from the competitive factors and apart from the definition, which may be the problem, but I think it was clearly understood, with all the intent and with all the discussion, that you're relating deposit rates to the comparable maturity in the Treasury securities' area.

And it seemed a little bit strange to us and precipitous that the moment rates started to come down, the committee said, "Well, we'll relate these deposit rates to the market only when rates are rising. But when they're falling, we'll establish a minimum ceiling." And that seems to be, you know, completely out of the context of what was trying to be established in having a market-related movement of rates.

We felt let the market test it and see what happens, whether we can't attract funds at 9 as well as 9½ or 8¾, and particularly where all these cost pressures were bearing down very heavily. That's the dual reason for the objection, apart from any legalisms that are implicit in that kind of action.

The CHAIRMAN. What if the market rate is not the Treasury bill rate? You assume it is.

Mr. KLAMAN. Well, if you're going to relate deposit rates to some rate, then it should be related to it. If you want to have a different definition of market rate, the Congress I think was maybe deliberately vague. But I think it left no doubt—and certainly the actions were clear, that the rates were related to Treasury rates, whether you define them as such or not. That's exactly how the 6-month certificate works; that's exactly how the 30-month certificate worked. And all rates were coming down, precipitously, as you know.

I just was astonished by the precipitous action taken without giving the market a chance to work. The world would not have come to an end if they took this action 30 days later and said, "See, we told you what happened." It was not forecast; it happened. Remember, we went through 14 months of this.

The CHAIRMAN. Mr. Brooks, section 204 of the Depository Institutions Deregulation and Monetary Control Act provides that DIDC shall phase out and ultimately eliminate the limitation on the maximum rates of interest paid on deposits as rapidly as economic conditions warrant.

If I understand correctly, you are concerned that DIDC has taken such drastic action on the basis of legislation that provides for an orderly phaseout over a 6-year period.

Specifically, what do you feel would be more suitable action?

Mr. BROOKS. I'm not so sure I understand the question.

The CHAIRMAN. As I say, you—along with Mr. Klaman, too, I guess—feel that the phaseout was too precipitous, that the legislation provided not that they should be phased out, as the new Morgan bill would suggest, regularly over a 6-year period. But assume as economic conditions warrant——

Mr. BROOKS. Well, Mr. Chairman——

The CHAIRMAN. Under the economic conditions that prevailed when they took their action, what do you think they should have done that would be more suitable?

Mr. BROOKS. Mr. Chairman, I think that also it made reference in the act that, in addition to economic conditions warranting, consideration be given to the viability of thrift institutions.

The CHAIRMAN. Safeness and soundness.

Mr. BROOKS. That's right. And consideration as far as the housing industry was concerned.

Now, I went around this country between the time that H.R. 4986 became law. And I made many speeches, in my position as president of the U.S. League, and stated that we have 6 years to get our house in order, that we've got to start making rollover mortgages, renegotiable rate mortgages if you will. We've got to get our old assets out of our balance sheet.

The CHAIRMAN. Let me interrupt, Mr. Brooks, to say if you made that speech, you should have read the legislation first, because the legislation did not say it would be 6 years. It indicated it could be sooner than that, it could be in 2 years, or 3 years, or 4 years. Some people say it should have been in 6 weeks. But, at any rate, we didn't say it would take 6 years to adjust to this.

Mr. BROOKS. Of course you did not. However, the part in there about the viability of the thrift institutions, and with our particular situation, like we've been through, I would have thought it would have been reasonable at least that we would have time to get our earnings back into a condition that the actual—we would be in a position where we could better afford to pay market rates. But certainly when the DIDC took the action, we were not in a position where we could pay the market rates.

The **Chairman.** Let me ask you this. As of now, given the pres-nt market conditions or present economic conditions, are they uch as to warrant, in your judgment, any change at all, even a light change, in the limitation on maximum interest rates?

Mr. **Brooks.** Any change in the maximum?

The **Chairman.** Yes.

Mr. **Brooks.** Interest rates?

The **Chairman.** Yes.

Mr. **Brooks.** As far—are you talking about the ceiling, as far as he 9½ percent on a 2½-year certificate?

Well, at the present time, as I understand it, as of yesterday, the ½-year certificate went to 9.7, which means that we'll be paying t more than 10 percent. My answer would be no.

But the point is that the floors——

The **Chairman.** No, because you don't think that economic condi-ions should warrant this any more than that?

Mr. **Brooks.** To paying more?

The **Chairman.** More than the present ceiling?

Mr. **Brooks.** More than the present ceiling?

The **Chairman.** Yes, sir.

Mr. **Brooks.** Well, as I understand it, we can pay 11—rather, 9.7, which is about 10⅕ percent on the 2½-year right now. So, my answer would be that the present ceiling, if you're talking about, ay, 12 percent, I don't think that should be changed.

The **Chairman.** All right, sir.

Mr. Gunderson, there have been several recommendations that ny depository institution having a significant share of its loans in mortgages be given the differential now given the thrifts. In other words, many banks in Wisconsin tell me that they have 40 or 50 percent of their portfolio—and in some cases more than that—in mortgages. Whereas, savings and loans have more than that, a higher percentage, 70 to 80 percent in many cases.

BASE INTEREST RATES ON PERCENTAGE OF LOANS

At any rate, as an interim step, what would be wrong in providing that the same differential would apply, not keyed to whether you're an S&L or a bank, but keyed to whether or not you have a certain percentage of your assets in housing? And that would be particularly true in view of the fact that the nature of our S&L's are changing now; they're getting more into consumer loans and into other things, because of the bill passed last year. Should we key the interest rate an institution can pay to a certain percentage of its loans and mortgages. What do you think of that?

Mr. **Gunderson.** Senator, my bank is one of those banks. We have 40 percent of our loans in home mortgages. But nevertheless, I think it goes back to our original premise, the ABA's original premise, that the differential is not the problem here. It's the inability of financial institutions to compete and attract funds.

I think the savings rate in this Nation is a prime indicator of that. We simply are not drawing the funds into our financial institutions. We aren't giving people a reason to save. We're giving them a reason to go outside of the regulated financial community and go elsewhere with their money.

So, you know, I go along with their original hypothesis. I think that housing differential, all that does is discriminate against the people who want to do business with my bank versus someone that wants to do business with an S&L or a thrift institution, because the loans in my community——

The CHAIRMAN. Do you agree at all with the fundamental principle that lies behind the differential, which is not, as I understand it, to give advantage to an institution, but to direct, as much as we could, more funds into housing. This recognizes that housing is a high national priority, that it's very, very dependent on credit, that it has suffered seriously from credit crunches much more than any other section of the economy, because it is so sensitive. Is this not the reason that a differential—a modest, limited differential—is viewed as important?

Now, it's been suggested that in view of the fact that we are modifying the S&L's, that if anything, if we retain the differential for a period, we ought to put it into housing.

I think Mr. O'Brien made a very eloquent and strong pitch, on the basis of recognizing the importance of the housing industry.

Mr. GUNDERSON. We certainly recognize the importance of the housing industry, Mr. Chairman. It's not that. It's just that I'm still convinced that that one-fourth percent differential isn't going to bring the housing industry back anywhere near where any of us would want to see it. I think the combined resources of banking and the thrift could hardly meet the need for housing.

We need to develop ways to access other funds. The cost of housing has become a big problem. Inflation is, you know, the problem that all of us are really ending up you know, in bed with, creating the problem.

The CHAIRMAN. Let me ask Mr. Cugini if he'd like to comment on that.

Mr. CUGINI. Well, Senator, again I have to agree that certainly inflation is our biggest problem. I certainly think the combined resources of banks and thrift institutions, if they were directed to housing, would certainly help solve the problem, but that would leave us shy in other areas. Credit unions, through this H.R. 4986, have been permitted to make mortgage loans. Of course, not having the availability of funds—and we've suffered like some of the other people; we're not able to get into that as much as we would like to at this point in time.

The CHAIRMAN. How much are you in it? I remember 30 years ago I got a mortgage on my house in Madison. I got it from a credit union.

Mr. CUGINI. It's just recently that Federal credit unions were able to get into it. But I am from Rhode Island and a Rhode Island State-chartered credit union. I have about 40 percent of our assets in home mortgages. Like the thrifts, I still have 5½ percent mortgages that are life insured, so that if a person dies, that balance is gone.

The CHAIRMAN. Mr. O'Brien, what's your feeling about this?

Mr. O'BRIEN. I could support a differential for housing for banks, but I think it would be an administrative nightmare. A bank would qualify one day, and it wouldn't the next day. I think that the ayer of bureaucratic morass that would have to be created to nonitor it wouldn't be worth the effort.

The CHAIRMAN. Do you see any significant change as a result of he big bill that we passed, giving so many powers to the S&L's as ime develops so that the institutions may become somewhat more fficient and attractive?

Mr. O'BRIEN. Definitely.

The CHAIRMAN. If that's the case and the reasoning behind the hasing out of regulation Q is right, then it seems to me that any rgument that remains for the differential would have to be relatd to housing needs.

Mr. O'BRIEN. I agree. We could support a differential for comercial banks or any institution that favors housing, but you'd ave the tax implications; you'd have the administrative plans; and ou'd have the question of how much of a percent of assets is nough to qualify for the differential. Is it 50, 60, 70, or 80, as an &L, for instance, would be?

The CHAIRMAN. Let me go right across the panel and ask you our feeling. I think I've gotten—some of you have already reponded in your various opening statements, but I want to make it lear so that we have a full understanding.

COMMENTS ON S. 2927

I'd like you to address yourself to two questions relating to the Morgan bill, which, as you know, would phase out the differential n the basis of having a differential no less than a quarter of a ercent, 25 basis points, as of the middle of 1981. Then it would go o no less than 20 basis points, no less than 15, no less than 10, no ess than 5.

I'd like to ask you if you favor that, or if it would make any lifference to you or you would prefer to eliminate the "no less han", so that we would make it specific, thus making the phaseout n a predictable basis. In other words, it would be 25 basis points he first year, and 20 basis points, then 15, then 10, and then 5. As t is now, it can be anything with the floor of the 25, 20, and 15.

Let me start with Mr. Gunderson and go right across the table.

Mr. GUNDERSON. Mr. Chairman, in our testimony we indicated hat we are opposed to S. 2927. We feel that it's counterproductive o everything that's gone into the development of H.R. 4986. There vas a great deal of thought, and there were hearings, and we did ome compromising and others did some compromising. We feel hat what we have is workable and doable and that the authority o phase out the differential is already vested with the DIDC. We eel that's the appropriate place for it, and we feel it would be nfortunate to alter the legislation 5 months later.

The CHAIRMAN. My point is that the Morgan legislation would over accounts after 1975, which the original legislation didn't ouch. It left it flexible to the DIDC to make their own decision.

Mr. GUNDERSON. It's my understanding that this would also xtend to IRA's and Keoghs, on all other kinds of accounts on vhich we have parity now. It's discriminatory to our savers in just nother side area. This is another problem that we have.

The CHAIRMAN. In any event, the ABA's position is in opposition o the bill as it is, or even if it were modified?

Mr. GUNDERSON. That's correct, Mr. Chairman.

The CHAIRMAN. Mr. Miller?

Mr. MILLER. The American Savings and Loan League, as I've stated in my testimony, supports S. 2927 as it is written currently, though personally I would like to see, as Mr. Brooks suggested, that there at least be 1 year review time set aside. I don't think the differential needs to come down as quickly as stated in the bill, but that's just my personal opinion. Certainly the smaller institutions, even with the new assets that are implemented in the new regulation—it would take us a longer period of time to get them onboard because of the fact that it would take us more time for staffing. You're looking at the president of a community savings and loan and also a director of janitorial services at that savings and loan also, so as a result, the smaller institutions would have a harder time bringing the new asset powers onboard.

The CHAIRMAN. Thank you. Mr. Brooks?

Mr. BROOKS. Well, Mr. Chairman, as far as the phasing out period—I think Senator Morgan's bill is laudable. There comes a question, which I think was pointed out by Mr. Miller, many of our associations simply would not be in a position perhaps for this phaseout to start within 1 year. I think it would be better if we give it a chance—all of the associations to come online with earnings sufficient over a period of time that we could afford to pay it. At the very least, I think, rather than writing the 5 basis points each year into law, if this could be continued for 1 year as was indicated—I believe that H.R. 4986 called for a report at the end of the year as to the effect of removing the differential—if it could go to that period of time and then S&L's would have a chance to recover from the earnings situation that we've just been through, and then at that time if we are in a position, perhaps it would be well to go ahead and phase it out.

It would be far better, in our opinion, that the differential would be removed at the end of the 6 years, as regulation Q, then, has been gradually phased out.

As to your question on the less than the one-quarter of 1 percent, I could see that possibly, particularly with the devastation we've just been through, that housing might be in such a position that there would be a need for greater than a quarter percent differential to bring it back. Whether the banks got it or whether we've got it, it's a housing differential, and there may be a need for it. But certainly we should have at least a quarter percent.

The CHAIRMAN. Mr. Hutchinson?

Mr. HUTCHINSON. Mr. Chairman, the National Association of Federal Credit Unions has been on record for 5 years as being opposed to regulation Q. We have been from the very outset. We're not subject to it. We felt right along and still feel it has not worked, but it is presumptuous for a financial institution that's not subject to it to superimpose its opinion upon those institutions that are subject to it.

In specifics, the bill as it's written—the "not less than"—gives us a little bit of concern. We feel it probably would not ratchet down quickly enough. If we could see in the bill a specific ratcheting down so that at the end of 6 years it is gone, we could certainly support it.

The CHAIRMAN. Mr. Cugini?

Mr. CUGINI. Mr. Chairman, CUNA has always been on record for ne elimination of regulation Q. I think we would have to view the Iorgan bill as an extension of the 6-year period, that we would ust as soon operate in an environment of market rates, free narket rates.

The CHAIRMAN. Thank you. Mr. Klaman?

Mr. KLAMAN. Mr. Chairman, I've got to say that our industry as not addressed itself to this specific question yet, but it's clear to ne that we would obviously favor encompassing post-1975 instruments under Q in this differential. The problem clearly is the hasing down so rapidly.

I would have to ask the committee a question as to why the hilosophical and basic difference between how you would address ost-1975 instruments with pre-1975? If over 6 years the committee aid the differential should be 25 basis points on savings deposits—his has become increasingly less important—why not keep it at 25 asis points for the nonsavings deposits on time schedules, so here's some consistency?

The CHAIRMAN. You're asking a good and pertinent question. he Congress has not taken a position, so I can't tell you what the hilosophical reasoning behind it is, but Congress never has felt hat they had to be logical, as you know.

Mr. KLAMAN. We've got two opposing forces here. Maybe if we've ot a bill that stood on its own feet rather than being tied to omething which most of us wanted, you wouldn't put something onverse there. It does trouble me. The logic is not present if twohirds to three-fourths of our deposit structure is on these new nstruments. So what meaning does it have if the Congress passes I.R. 4986 and says "Keep the differential"?

The CHAIRMAN. The meaning is this: One, that we're trying to et rid of what we had before 1975, and we don't want to introduce new differential into instruments that aren't touched by it at the resent time. Another reason, we want to go away from it, not oward it, or even compromise; we want to get rid of it.

We want to go to the market. I think the market forces are etter to encourage savings, and encouraging savings is a big element in fighting inflation.

Mr. KLAMAN. We do too, by the way. Just let the record record ne fact that we have for 20 years been in favor of it.

The CHAIRMAN. You've been outstanding in fighting for exempion of interest on savings accounts from income taxes, and I'm vith you. You're dead right on that. It's a very good position. We're noving slowly in that direction.

Mr. KLAMAN. That statement is worth my presence here all ight. Thank you very much. [Laughter.]

The CHAIRMAN. Mr. O'Brien?

Mr. O'BRIEN. Mr. Chairman, the National League suggested the haseout of regulation Q but not the differential. On the Morgan ill, we could not get a unanimous vote in the executive committee f the National League. Indeed, we didn't even get a majority vote n favor of that bill; however, we are polling our membership at ne present time, and I will send you the results of that poll.

The CHAIRMAN. You say you didn't have a decision within what? The directorship?

Mr. O'BRIEN. That's right. We met on that last week.

The CHAIRMAN. When do you expect to have it?

Mr. O'BRIEN. I would say within a week to 10 days, possibly sooner.

The CHAIRMAN. We'd appreciate it, I'm sure, and Senator Morgan would, I'm sure, too.

Gentlemen, thank you very much. You've made a very good record. Thank you.

[Whereupon, at 4:20 p.m, the hearing was adjourned.]

[Additional material received for the record follows in the appendix:]

APPENDIX

RECENT LETTERS FROM SENATE BANKING COMMITTEE MEMBERS TO THE DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS,
Washington, D.C., May 16, 1980.

Hon. PAUL VOLCKER,
Chairman,
Federal Reserve Board, Washington, D.C.

DEAR MR. CHAIRMAN: The Depository Institutions Deregulation Committee recently proposed a regulation which would effectively prohibit banks and thrift institutions from offering gifts and premiums to attract deposits.

We oppose any such regulation and we find it somewhat disturbing that one of the first actions of the Deregulation Committee would be to further restrict a financial institution's range of legal activities.

The financial industry in this country took a giant step toward a more competitive market structure with the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980. We think this legislation will prove to be of tremendous benefit to both the industry and the customers it serves in the coming years. However, the action you have recently taken with regard to the prohibition on promotional gifts is a step backward from the earlier gains we have made.

As long as Regulation Q remains on the books, and financial institutions are precluded from offering competitive rates of interest to the saver, institutions should not be prohibited from using merchandise as a means to attract deposits.

We would urge the DIDC to carry out the deregulatory spirit of Public Law 96-221 by not approving this prohibition on bank gifts. If the members of the DIDC are concerned about the difficulty of enforcing the present regulations on gifts, most of those concerns could be alleviated by revising the regulations to cover all costs as suggested by the DIDC staff rather than by prohibiting gifts altogether.

Sincerely,

DONALD W. STEWART.
WILLIAM PROXMIRE,
Chairman.

U.S. SENATE,
Washington, D.C., May 20, 1980.

Hon. PAUL A. VOLCKER,
Chairman, Board of Governors,
Federal Reserve System, Washington, D.C.

DEAR HONORABLE VOLCKER: I am writing in regard to the meeting of the Depository Institutions Deregulation Committee scheduled for today and to the Committee's consideration of the question as to whether it is appropriate to eliminate the present interest rate differential between thrift institutions and commercial banks on six-month money market certificates which yield less than nine percent.

While I realize that you and the other members of the Committee may only review this issue and not make any determination today, I do want to express my concern that in looking at the issue the Committee give consideration to the broad effects the interest rate differential has not only on the financial stability of thrift institutions but also on those served by such institutions. I am particularly concerned that the depressed state of the housing industry could be adversely affected by the outflow of funds from thrift institutions if the differential on money market certificates is eliminated.

If the Committee does decide to revise the differential regulation, I would suggest that it not eliminate the differential altogether but adopt a rule which promotes competition for funds among different types of financial institutions and ensures the continued availability of funds for housing needs. For example, the Committee could retain the differential but allow all depository institutions, be they thrifts or commercial banks, which invest at least a majority of their assets in housing loans to offer the differential on six-month money market certificates. This type of alternative should be considered to ensure that the focus of the Committee's review of the differential issue takes into account the original purpose of the differential.

Sincerely,

JAKE GARN.

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS,
Washington, D.C., May 22, 1980.

Hon. PAUL VOLCKER,
Chairman, Depository Institutions Deregulation Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: We understand that the DIDC has determined to close its meeting to the public when it considers the matter of the differential relating to money market certificates.

In establishing the DIDC, the Congress intended that its meetings would be open to the public under the Sunshine Act unless there would be a specific adverse effect on a financial institution.

While fund flows and interest rates generally have an impact on financial institutions, it is difficult to see how a public discussion of the differential on money market certificates could result in any adverse effect on financial institutions.

The matter of the differential has been discussed for years in public. Precisely because it does involve competition between classes of institutions and consequent impact on savers, is the best reason to open such a meeting of the DIDC to the public. The collateral effects on safety and soundness of institutions appears to be tenuous at most and clearly outweighed by the public's need to know how the DIDC proposes to go to market rates in six years.

We look forward to your early reply on this subject involving as it does a matter of first impression of the operation of the DIDC.

Sincerely,

WILLIAM PROXMIRE,
Chairman.

JAKE GARN,
Ranking Minority Member.

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS,
Washington, D.C., June 6, 1980.

Mr. WILLIAM S. MORTENSEN,
President, National Savings & Loan League,
Washington, D.C.

DEAR MR. MORTENSEN: Thank you for your letter of May 30 concerning the recent actions by the Depository Institutions Deregulation Committee. You indicate the decision to restrict the rate differential on money market certificates and to establish minimum ceilings on these certificates and on thirty-month certificates "above declining market rates" is clearly contrary to the intent of Congress in the passage of H.R. 4986. I have carefully reviewed the actions taken by the Deregulation Committee and while I do not necessarily agree with them (the rate ceiling formula seems to be needlessly complex) I do not believe they are beyond the authority of the law or contrary to Congressional intent.

With regard to the differential, it is clear that H.R. 4986 requires the differential. it is clear that H.R. 4986 requires the differential to be maintained on all categories of accounts established prior to December 10, 1975 as provided under Public Law 94-200. Congress could have amended Public Law 94-200 to require the differential to be maintained on all categories of accounts and not just on those in effect on December 10, 1975. In fact, there were some who urged Congress to do just that in order to reverse the decision of the regulators to eliminate the differential on six-month certificates whenever the Treasury discount rate on six-month bills falls below 9 percent. However, in the end Congress chose not to do so. It is obvious, therefore, that Congress intended to vest discretionary authority on post-December

10, 1975 accounts with the Deregulation Committee. Since the six and thirty-month certificates were authorized after December 10, 1975, it is clear that the Deregulation Committee has the discretionary authority, under the law, to alter the differential. Some members of Congress may disagree with the wisdom of this decision. Nonetheless, I believe the Deregulation Committee acted within its legal authority.

With regard to the minimum ceilings on six-month and thirty-month certificates, I do not believe the establishment of these requirements of H.R. 4986 which prohibits the Deregulation Committee from increasing deposit rate ceilings above market rates during the six-year phase-out period. Since the statute does not define the term "market rates", the Deregulation Committee has substantial flexibility to define what market rates are. The Committee could, for purposes of 204(b), take into account current rates on Treasury obligations, U.S. agency obligations, rates on commercial paper notes or bonds, rates on money market funds, other market instruments, or even its own estimate of what financial institution deposit rates would be in the absence of regulation. Moreover, all of these rates could be adjusted to take into account variations in liquidity, safety, maturity, and tax considerations, and rate computation methods.

At the time the minimum ceilings went into effect on June 2, market rates by any measure were generally at or above the minimum ceilings. For example, the yield on six-month Treasury bills was 8.47 percent which is well above the minimum ceiling of 7.75 percent. Likewise, the yield on thirty-month Treasury notes was 9.17 percent compared to a minimum ceiling rate of 9.25 percent for banks and 9.50 percent for thrift institutions. Given the liquidity and tax advantages of Treasury obligations, I do not believe one can fairly conclude that the minimum ceiling rates on thirty-month certificates were in excess of Treasury rates at the time they were established.

Your letter points out that market rates are now declining and implies that in the near future the minimum ceiling rates on six-month and thirty-month certificates may exceed market rates. The thrust of your argument seems to be that the Deregulation Committee has a duty to anticipate any potential decline in market rates and that it cannot set rate ceilings in excess of current or anticipated market rates. There is nothing in the statutory language of H.R. 4986 or in its legislative history to support such a reading. If the Congress intended the Deregulation Committee to anticipate future changes in market rates when setting rate ceilings, it would have said so. The only statutory directive to the Deregulation Committee is not to increase rate ceilings in excess of market rates at the time the increase takes place.

Your apparent reading of the statute is further eroded by the fact that the Statement of Managers specifically indicates the Deregulation Committee has the authority to reduce rate ceilings if economic conditions warrant. If your forecast of a future decline in market rates is accurate, the legislation already provides the Deregulation Committee with the means for dealing with any problems that might arise. Therefore, there is no need for the Deregulation Committee to attempt to anticipate future declines in market rates when setting rate ceilings.

It should be emphasized, however, that the legislation merely authorizes a reduction in rate ceilings if the Deregulation Committee determines that economic conditions so warrant. The Act imposes no affirmative duty to reduce rate ceilings automatically in order to maintain some fixed relationship with market rates. Indeed, Congress clearly intended that the Deregulation Committee increase rate ceilings as rapidly as feasible in order to pave the way for their utilimate elimination as indicated under Section 202(b). Reducing rate ceilings in accordance with some fixed formula would be totally inconsistent with the purposes of the legislation.

Finally, you raise the important issue of whether the Deregulation Committee was in full compliance with the Government in the Sunshine Act when it held two of its meetings in executive session. I agree that there are serious questions involved in the decision to close these meetings to the public. In that connection, I and Senator Garn wrote to the Deregulation Committee to express our concern that the deliberations of the Committee be open to the public. A copy of our correspondence with Chairman Volcker is enclosed for your information.

Sincerely,

WILLIAM PROXMIRE, *Chairman.*

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS,
Washington, D.C., May 23, 1980.

Chairman PAUL VOLCKER,
Depository Institutions Deregulation Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: It has been reported that the Depository Institutions Deregulation Committee will consider the advisability of eliminating the rate differential on money market certificates which otherwise will be restored when Treasury bill rates fall below 9 percent. Any action on the differential would have to strike a delicate balance between preserving the soundness of financial institutions, maintaining credit flows for housing, agriculture and small business, and providing equity for savers. For these reasons, Congress left the issue of the differential on accounts created after December 31, 1979 to be decided by the Deregulation Committee.

Hopefully, the Deregulation Committee will carefully assess the impact of restoring or eliminating the differential before taking any action. I believe the Congress clearly intended that the Deregulation Committee exercise its best judgment on such matters. Accordingly, I have taken no position on this issue. Instead, I urge the Deregulation Committee to decide the issue strictly on its merits without reference to outside pressure.

Sincerely,

WILLIAM PROXMIRE, *Chairman.*

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS,
Washington, D.C., May 28, 1980.

Hon. PAUL VOLCKER,
Chairman, Board of Governors, Federal Reserve System, Federal Reserve Building, Washington, D.C.

DEAR MR. CHAIRMAN: Attached please find a letter from Mr. Jim McKibben, Vice President, Edmac, Inc., Bellaire, Texas, which is self-explanatory. It seems Mr. McKibben makes a good point regarding letting the banks decide whether or not they want to continue offering premiums as a marketing tool. What data does the Fed have which shows abuse of the use of premiums by financial institutions or evidence that such use is inherently harmful?

Sincerely,

JOHN TOWER.

U.S. SENATE,
Washington, D.C., June 5, 1980.

Chairman PAUL VOLCKER,
Depository Institutions, Deregulation Committee,
Federal Reserve Building, Washington, D.C.

DEAR MR. CHAIRMAN: On May 6, 1980, the Depository Institutions Deregulation Committee proposed a ban on premium promotions for all financial institutions. While I fully recognize the directives of Public Law 96-221 regarding interest rates, I do not feel that the banning of all premiums offered to induce savings is an appropriate step.

There have been arguments made that if premiums are to be banned, then we should deny banks and savings and loans the right to advertise, which is another cost of doing business. Frankly, I do not consider premiums a threat to any of the major policies of the Committee. While primarily a vehicle for small savings and loans to encourage savings, there are no doubt that some large urban banks have been engaged in a bargaining war over premiums. For the majority, premiums remain a device for seeking savings and capital rather than a means of evading interest ceilings or any other government policy.

Whether advertising or premiums are used to encourage savings, I cannot believe that it is in the interest of our economy to discourage efforts at improving our savings rate. Premiums have been and remain primarily marketing tools.

In many ways this proposal flies in the face of deregulation and of the President's anti-inflation program which seeks to encourage individual savings. While I do not address here the interest of the premiums industry, which are substantial, or the abuses which may have occurred in some cities, which may be addressed with existing regulatory authority, I do feel that these considerations should be on the mind of the Committee.

For my part, I would urge the need to encourage savings, the desirability of continuing aspects of current premium regulation without succumbing to the desire to eliminate controversy via an outright ban on premiums, and the desirability to carefully consider the impact of such a rule on the public perception of the role of the Committee.

With all best wishes, I am

Sincerely,

ROBERT MORGAN.

U.S. SENATE,
Washington, D.C., June 5, 1980.

Hon. PAUL VOLCKER,
Chairman, Depository Institutions Deregulation Committee,
Federal Reserve System, Washington, D.C.

DEAR MR. CHAIRMAN: I am writing in connection with the proposal by the Depository Institutions Deregulation Committee to prohibit the offering of all premium programs by financial institutions.

Many of my constituents have contacted me to express their deep concern about this proposal. I share their opposition to any such proposal, and frankly find it disturbing that one of the first actions of the deregulation committee would be to circumscribe further the ability of financial institutions to attract deposits.

The committee's proposal, as well as the brief comment period, has created a substantial degree of uncertainty and confusion among financial institutions, the premium and advertising industry, and consumers. I am advised that the status of premium arrangements, which were entered into months in advance of the committee's announcement, have been thrown into complete uncertainty.

While the committee has recently extended the original comment period of 30 days by an additional 30 days, I strongly urge the committee to extend the comment period for a substantially longer period of time in order to allow all interested parties adequate time to evaluate the consequences of the proposed ban, and to consider possible alternatives which might address certain abuses which I am advised caused the committee to act initially.

I appreciate very much your consideration of this request.

Sincerely,

RICHARD G. LUGAR.

U.S. SENATE,
Washington, D.C., June 11, 1980.

DEPOSITORY INSTITUTIONS DEREGULATION COMMITTEE,
Federal Reserve Building,
Washington, D.C.

GENTLEMEN: I am enclosing a letter from a constituent which comments on the prolixity of the Deregulation Committee's recent rules on the adjustment of interest rate ceilings.

While I understand the complex nature of the actions, I feel that the communication to the industries and the public lacks clarity. It is especially burdensome to small institutions. As a strong supporter of understandable and brief governmental communications with the public, I urge a greater effort be made to take actions which are understandable by, and make sense to, the public. Confidence in government suffers when rules are unnecessarily complicated and are inadequately communicated.

Sincerely,

ADLAI E. STEVENSON.

STATE BANK OF HERSCHER,
Herscher, Ill., June 5, 1980.

Senator ADLAI E. STEVENSON,
Washington, D.C.

DEAR SENATOR STEVENSON: Enclosed are copies of the new "Inter-Related Actions" for adjusting interest rate ceilings for the 6-month and 2½-year Certificate of Deposit. The enclosure is submitted from the Depository Institutions Deregulation Committee (DIDC) which is the result of the Banking—Savings & Loan—Credit Union bill which was enacted by the Congress this past March.

If you would please read this you will understand why many of us are more confused now than we were prior to the regulation that was supposed to make all this simpler! It is difficult enough for management; but consider the tellers, etc., that have the constant contact with the public and their various questions. Not only will our staff be confused but also, and more important, the consumer.

I propose this test to you and that is to read the enclosed and set aside for 30 minutes; then do some role playing with one of your staff members. You being the teller and the staff member being a consumer that desires information concerning investing in the institution you represent. It is difficult for me to believe that this is the intent of the Congress. Whatever happened to simplicity!

Sincerely,

CHARLES M. RIKER, *President.*

U.S. SENATE,
COMMITTEE ON COMMERCE, SCIENCE,
AND TRANSPORTATION,
Washington, D.C., June 12, 1980.

Hon. PAUL A. VOLCKER,
Depository Institutions Deregulation Committee,
Federal Reserve Building, Washington, D.C.

DEAR PAUL: As you know, the Committee's proposed rule prohibiting premiums on bank deposits has engendered a great deal of consternation among bankers and premium producers and distributors.

I understand that there have been some abuses of the existing rules on premiums, and I sympathize with your problem of enforcement. Nevertheless, a less sweeping approach to the problem would be preferable. Appropriate use of premiums is simply a facet of competition among financial institutions, and I do not think it wise to expand federal involvement beyond current practices.

I would appreciate it if you would share these views with the other members of the Committee. Before a final decision is reached, I would urge careful consideration.

Warmest regards,

NANCY LANDON KASSEBAUM,
U.S. Senator.

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS,
Washington, D.C., June 17, 1980.

Hon. PAUL VOLCKER,
Chairman, Board of Governors,
Federal Reserve System, Washington, D.C.

DEAR MR. CHAIRMAN: We are writing in connection with the proposal announced May 7 by the Depository Institutions Deregulation Committee to prohibit the offering of all premium programs by financial institutions.

Since the Committee's announcement, we have received complaints from several groups that have described the substantial disruptive effects that already have resulted from adoption of the proposed ban.

Our primary concern centers on the Committee's proposed absolute ban on long-established use by banks and other depository institutions of premium programs in connection with the establishment of new offices and increasing or opening new accounts. Our concern is sharpened by the current uncertain nature of commercial and financial markets. In fact, it seems likely that the Committee's proposed ban may seriously diminish the ability of institutions to attract and increase deposits—a result which clearly runs counter to the major policies of the regulatory agencies and the government.

The Committee's proposal, in conjunction with the extremely brief comment period of 30 days that was originally provided, has created a high degree of uncertainty and confusion among financial institutions, the premium and advertising industry and consumers. Indeed, the status of premium arrangements which were entered into months in advance of the Committee's announcement have been thrown into complete uncertainty.

We would prefer that the Committee withdraw its proposed rules of May 7th. If it does not, we urge the Committee to prepare an economic impact study which fully considers all the foreseeable consequences of the Committee's proposal. Such a study

best copy available

s imperative before the proposal is finally acted upon, to ensure a full review and ndependent economic justification for any action taken.

In addition, because the Committee's proposal would affect a broad range of liverse interests, we also urge that the Committee agree to hold a public hearing so hat those affected by this action can express their views directly to the Committee nembers.

Sincerely,

William Proxmire,
Chairman.

Donald Stewart.
Jake Garn.
Nancy L. Kassebaum.
George J. Mitchell.
Alan Cranston.
Dick Lugar.
John Tower.

U.S. Senate,
Committee on Banking, Housing, and
Urban Affairs,
Washington, D.C., June 23, 1980.

Mr. Norman R. V. Bernard,
Executive Secretary, Depository Institutions, Deregulation Committee,
Federal Reserve Building, Washington, D.C.

Dear Mr. Bernard: I am writing in connection with the proposal announced May 7 by the Depository Institutions Deregulation Committee ("Committee") to prohibit the offering of all premium programs by financial institutions.

Since the Committee's announcement, I have received complaints from several groups that have described the substantial disruptive effects that already have resulted from adoption of the proposed ban.

My primary concern centers on the Committee's proposed absolute ban on the long-established use by banks and other depository institutions of premium programs in connection with the establishment of new offices and the increasing or opening of new accounts. My concern is sharpened by the current uncertain nature of commercial and financial markets. In fact, it seems unlikely that the Committee's proposed ban may seriously diminish the ability of institutions to attract and increase deposits—a result which clearly runs counter to the major policies of the regulatory agencies and the government.

The Committee's proposal, in conjunction with the extremely brief comment period of 30 days that was originally provided, has created a high degree of uncertainty and confusion among financial institutions, the premium and advertising industry and consumers. Indeed, the status of premium arrangements which were entered into months in advance of the Committee's announcement have been thrown into complete uncertainty.

Although the Committee has recently extended the original comment period of 30 days by an additional 30 days, the serious potential effects of this action contemplated by the Committee warrant a substantially longer period of review. I urge that instead of the 30-day extension, a 120-day extension of the current comment should be provided in order that a complete review of the situation may take place. Only a 120-day extension would afford interested parties the necessary time period to evaluate carefully and fully the consequences of the proposed ban and to consider possible alternatives to the proposed total ban. Furthermore, such an extended comment period would enable the agencies represented on the Committee during this period to prepare an economic impact study which fully considers all the foreseeable consequences of the Committee's proposal. Such a study is imperative before the proposal is finally acted upon, to ensure a full review and independent economic justification for any action taken.

In addition, because the Committee's proposal would affect a broad range of diverse interests, I also urge that the Committee agree to hold a public hearing so that those affected by this action can express their views directly to the Committee members.

Sincerely,

John Heinz, *U.S. Senate.*

U.S. Senate,
Washington, D.C., June 24, 1980.

Hon. Paul Volcker,
Chairman, Depository Institutions Deregulation Committee,
Federal Reserve Building, Washington, D.C.

Dear Chairman Volcker: I am writing to you in your capacity as Chairman of the Depository Institutions Deregulation Committee to urge that when the Committee meets tomorrow, June 25, it reevaluate very carefully the decisions taken at its meeting of May 25 regarding interest rates, in particular the decision to eliminate the differential on the six-month Money Market Certificate. In this period of economic uncertainty, the nation's thrift institutions confront very difficult problems. It is therefore vitally important that the DIDC reviews its earlier actions to ensure that neither those actions, nor any others which the DIDC might contemplate, will have the effect of impeding the recent encouraging growth in the thrifts' deposits.

With regard to the earlier proposal by the DIDC to prohibit the offering of premiums or gifts by depository institutions upon the opening of a new account or an addition to an existing account, I note with satisfaction the decision of the DIDC to extend the comment period to July 16. I would urge the Committee carefully to identify and examine the implications of the proposed prohibition, and to study in detail the comments which it has elicited, before arriving at a decision on so far-reaching a proposal.

With best regards,
Sincerely,

Paul S. Sarbanes,
U.S. Senator.

U.S. Senate,
Committee on Banking, Housing, and
Urban Affairs
Washington, D.C. June 26, 1980.

Hon. Paul A. Volcker,
Chairman, Board of Governors,
Federal Reserve System, Washington, D.C.

Dear Chairman Volcker: I am writing to express my concerns about a recent rule adopted by the Depository Institutions Deregulation Committee regarding the penalty for early withdrawals of time deposit funds.

By adoption of a Committee rule effective June 2, time deposits of one year or less are subject to an early withdrawal penalty of three months' interest, regardless of how long the funds have remained on deposit, and time deposits with a maturity of more than one year are subject to an early withdrawal penalty of six months' interest. While I agree that there is a need for an interest penalty to deter early withdrawals of time deposits, I do not understand why it is necessary to extend the penalty to a reduction in principal, which would occur if a one year deposit is withdrawn during the first three months or a deposit of more than one year is withdrawn prior to the end of the first six months.

A deposit of funds in a bank or savings institution is not a security whose value may increase or decrease, and referring to a possible reduction in principal as an "interest penalty" does not make sense to me. Depositors must expect to incur interest penalties when funds are withdrawn prior to the maturity of time deposits, but I do not believe it appropriate to tell a depositor who, for example, needs funds from a two year deposit for medical operation, that a withdrawal penalty of six months' interest would have to be paid even though the funds have been on deposit for only two months.

I would appreciate receiving your comments as to the statutory basis of the Committee's new policy, whether such principal reductions have been required by the Federal Reserve or other Committee participants previously, and why a forfeiture of all earned interest would not be sufficient to deter early withdrawals within the first few months of a time deposit.

Sincerely yours,

Jake Garn.

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C., June 27, 1980.

Hon. PAUL VOLCKER,
Chairman, Depository Institutions Deregulation Committee,
Washington, D.C.

DEAR CHAIRMAN VOLCKER: Since the passage of the Depository Institutions Deregulation and Monetary Control Act of 1980, the Deregulation Committee created by that law has met and taken significant steps which have caused concern in the Congress and among our constitutents. We believe that it is imperative for the Committee to review carefully the actions it has taken already with an eye toward amendments and act with caution on the proposals under consideration for the future with an eye toward moderating them and conforming them with the law.

There is no doubt, even among the earliest sponsors of H.R. 4986, that deregulation of depository institutions was to occur gradually with due regard to the problems of various sectors of the financial community. Many of the actions of the Deregulation Committee appear to fly in the face of either the general directives or specific provisions of the law.

Specifically, the Committee has set minimum ceilings on interest rates for thirty month certificates of deposit above the market rates on Treasury bills. This runs counter to the clear language in Section 204 of Public Law 96-221 that the ". . . Committee shall not increase [interest rates] above market rates during the six year period beginning on the date of enactment of this title." The setting of these minimum ceilings on interest rates tends to discourage a needed decline in mortgage costs. Throughout Public Law 96-221, the Congress made its purpose clear—market rates should guide the Committee. not some artificial level above the market.

The elimination of the differential on money market certificates, except in a narrow ban, tied again to Treasury bill rates, concerns us. Just one week before the Committee acted, Home Loan Board Chairman Jay Janis told the Senate Banking Committee that if mortgage rates are to fall, ". . . it is essential that thrifts keep the differential when Money Market Certificate rates are below 9 percent, at least for the rest of the year."

The new rules go against the specific directive for a phased elimination of the differential and operate to the substantial disadvantage of a major element of the financial community.

Other Committee moves such as commercial bank offerings of thrift rates on rolled over money market certificates and stiff penalties for early withdrawal work against increasing the available funds for home financing and lowering interest rates which would benefit our entire economy.

Many of the Committee's actions appear to be slanted toward various economic policies which the Congress did not consider the business of the Committee. The Congress set forth its economic policies—the elimination of interest ceilings and a more competitive market—and directed the Committee to insure that this was carried out with the least injury to any financial institution. The Deregulation Committee appears to have decided that it will act to the benefit of the money markets without regard to the needs of thrifts to become sophisticated in their new powers and to develop their competitive skills, and without regard to the needs of the housing industry for mortgage financing. There has been little evidence of a balanced approach in the Committee's initial regulations.

We are concerned about the impact of the Deregulation Committee's initial determinations on the financial community and on the image of the Committee in its discharge of the Congress' directives. We urge you to reconsider actions previously taken and we will be pressing for close congressional scrutiny in the near future.

Sincerely,

DONALD W. RIEGLE, Jr.
JAKE GARN.
LAWTON CHILES.
ROBERT B. MORGAN.
JOHN MELCHER.
THOMAS F. EAGLETON.

U.S. SENATE,
Washington, D.C., July 3, 1980.

Hon. PAUL VOLCKER,
Chairman, Federal Reserve Board,
Washington, D.C.

DEAR MR. CHAIRMAN: I wanted to express my concern to you about the recent actions of the Depository Institutions Deregulation Committee regarding Money Market Certificates.

From my vantage point, the DIDC's actions to date have served to alienate members of Congress rather than building the base necessary to allow the Committee to carry out its mandate with the confidence and support of the Congress. I think this result is regretable and in my opinion, must be avoided in the future.

I have written you before regarding the DIDC's proposed ban on bank premiums. I oppose such a ban and I have talked to many of my colleagues who support my view. Subsequent to the DIDC's action on premiums, however, the Committee acted on the differential on Money Market Certificates. These actions in my opinion were precipitous and ill-timed. I fear that the impact of these actions was not carefully evaluated and that the effect on an already beleaguered home financing industry could be substantial.

I urge the Committee to re-evaluate its proposals and conduct a thorough review of their potential impact on the thrift industry.

Sincerely,

DONALD W. STEWART.

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, D.C., July 15, 1980.

Hon. PAUL VOLCKER,
Chairman, Depository Institutions, Deregulation Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: I find it nothing short of an outrage that the Depository Institutions Deregulation Committee (DIDC) has adopted a rule which will result in savers forfeiting principal and interest for withdrawals prior to maturity. Under the new rule, a saver who redeems his saving certificate prior to maturity will be assessed a penalty equal to three months interest on certificates of one year or less and a penalty of six months interest on certificates longer than one year. Moreover, unlike the previous regulation, the new penalty cannot only wipe out any interest that may have accrued—it can also reduce the saver's original principal.

Consider, for example, a saver who invests $10,000 in a 2½-year certificate of deposit with an annual interest rate of 10 percent. If he needs to get his money back after one month, he will be socked with a $500 early withdrawal penalty. When this penalty is offset against the approximately $83 in interest he earned during the month, his original principal will be reduced by $417. Instead of earning 10%, the saver will realize a negative yield of 50 percent.

What is even more ironic is that these penalties are not merely permissive—they are mandatory. A banker must charge them whether or not he considers them to be fair or proper. Many bankers have complained to me about these penalties as being too harsh and yet they have no choice but to impose them. The regulation by DIDC is just the reverse of most consumer protection laws. Government usually acts to restrain the most egregious practices in the marketplace. In this case, government is imposing the same egregious standard for an entire industry. This action can do nothing but erode depositor confidence in financial institutions and provide a further disincentive to save.

One of the principal reasons why Congress passed the Depository Institutions Deregulation and Monetary Control Act of 1980 was to enable insured institutions—both banks and thrifts—to compete for savers funds by paying a fair rate of return on savings. Interest rate regulation—or Regulation Q—adopted in 1966 in the most current form had become counterproductive. Savers were forced by Regulation Q to subsidize borrowers. Thrift institutions suffered fund outflows. Mortgage money became scarce. Capital formation was reduced to dangerously low levels. Why? Because the rate of return on savings at insured institutions was so low that people found it more economical to spend rather than save. This unjust government policy fueled inflation by encouraging consumption at the expense of saving. Savers took their money out of insured institutions and placed their savings in money market funds paying a fair rate of return.

Congress established the DIDC for the express purpose of phasing out Regulation Q and to provide equity to savers. It is to me incomprehensible that the DIDC, given the history of its establishment, would take the action it has and provide penalties to savers for early withdrawal that would not only forfeit their interest but eat into their principal. Savers work too hard for their money to be so penalized and treated so unfairly by government regulation.

The DIDC was set up to deregulate deposit rate ceilings, not to bludgeon savers. The DIDC action is directly contrary to the legislative history establishing it, and it is a travesty upon our efforts to give savers a break and to encourage savings.

The DIDC should immediately repeal these new penalties. I realize that some insured institution's earnings have declined. But it is grossly unfair to have depositors foot the bill. I am afraid that the DIDC has become a bizarre 20th Century Robin Hood: robbing savers while pushing the proceeds on bankers, many of whom consider the charges to be unfair. Will the DIDC be surprised when it finds that savings will be further discouraged and alternative investments which disintermediate funds from thrifts and banks encouraged? It is crystal clear to me that our financial system needs to have this action reconsidered by the DIDC.

Sincerely,

William Proxmire,
Chairman.

Independent
BANKERS ASSOCIATION OF AMERICA

OFFICE OF THE
PRESIDENT

[illegible]

June 18, 1980

The President
The White House
Washington, D.C. 20500

Dear Mr. President:

The recent action of the Depository Institutions Deregulation Committee (DIDC) in removing the differential permitting thrift institutions to pay a quarter percent more than commercial banks on six-month money market certificates when Treasury bill rates fall outside a specific range has been sharply criticized by representatives of the thrift industry. For example, following a meeting with you on June 9, 1980, the president of the U. S. League of Savings Associations issued a press release stating that he had advised you that actions taken by your appointees will keep mortgage rates high, reduce the availability of mortgage money and prolong the housing recession.

The 7300 members of the Independent Bankers Association of America, mainly small banks with assets of $25 million or less, who contribute substantially to the financing of housing their communities, believe the action taken by the Depository Institutions Deregulation Committee could improve the ability of small banks to expand their lending to housing by removing a significant handicap in competing for short-term time deposits. In fact, our position would be that the Deregulation Committee did not go far enough in removing the differential and should have, at the very least, signaled that the differential on the popular six-month certificate would be eliminated next January 1 when thrifts will be able to offer checking accounts under the power of the new bill you signed into law on March 31, 1980.

Small banks are significant participants in the
ousing market. Between 1970 and 1978, for example, almost
e-fourth of the funds loaned by these banks were secured
real estate, principally one-to-four family homes.
rthermore, these banks are heavily involved in lending to
all business and agriculture. In 1978 they accounted for
er 60 percent of the credit extended to agriculture by all
mmercial banks. As you know, agriculture and small business,
well as housing, have been severely impacted by the
onomic conditions that have developed over the past year.
e action taken by the Deregulation Committee was a clear
cognition of the need to develop a better competitive
lance among depository institutions to meet the credit
eds of all these vital sectors of our economy.

We therefore, believe that the action taken by the
IDC was not only long overdue but also hopefully only a
irst step toward giving commercial banks an equal oppor-
unity to compete for funds needed to meet the credit needs
f their communities for housing, for small business and for
griculture.

Sincerely,

Thomas F Bolger

Thomas F. Bolger
President

cc: Members of the
Deregulation Committee

Independent
BANKERS ASSOCIATION OF AMERICA
OFFICE OF THE
PRESIDENT
[illegible]

June 30, 1980

Honorable Paul Volcker, Chairman
Depository Institutions Deregulation Committee
Board of Governors, Federal Reserve System
20th and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Mr. Chairman:

The Deregulation Committee, on which the Chairman of the National Credit Union Administration sits as a voting member, has the authority for establishing limitations on the maximum rates of interest and dividends which may be paid on all deposits and accounts held by banks and savings and loans. Such limitations are in place and under continued review.

Unfortunately, the National Credit Union Administration is not legally bound to accept the decisions of the Deregulation Committee. However, the Conference Report on P.L. 96-221 does specify that the NCUA should "work towards parity of interest rates..."

The purpose of this letter is to alert the Deregulation Committee to a situation which has developed in Michigan, where a Federal Credit Union is advertising a series of share certificates yielding 9 percent or better. Competing instruments at banks and S&Ls can not be offered at anywhere near this rate.

Attached is a letter that the IBAA has received from a small bank which competes directly with this credit union. The President of the bank points out that deposits have already been lost because of this unfair interest rate advantage and that additional deposit losses are anticipated.

We would be very appreciative if you could bring this matter to the attention of the Deregulation Committee at its next meeting, looking towards fashioning a remedy to this tremendously inequitable situation.

Sincerely,

Thomas F. Bolger
President

TFB/nls

Attachments (2)

cc: Members of the Deregulation Committee
Representative Fernand St Germain, Chairman
Representative Chalmers P. Wylie
Representative James J. Blanchard

HILLMAN STATE BANK

P. O. Box 27
HILLMAN, MI. 49746
Phone - Area 517
742-4241 or 742-4222

James S. Braddock
President

June 27, 1980

Mr. Kenneth Guenther
Executive Director, I.B.A.A.
1625 Massachusetts Avenue N.W.
Second Floor
Washington, D. C. 20036

Copy Furnished:
Mr. Merl B. Highland
President, Kalamazoo County State Bank
223 North Grand
Schoolcraft, Michigan 49087

Dear Mr. Guenther:

The purpose of my letter is to confirm a telephone conversation of this date with Mr. Merl B. Highland, our legislative representative for the Michigan Association of Community Bankers, regarding the activities of a federal credit union located in our area where they are paying the following rates on their new share certificates (see enclosure):

$10,000.00	6 months	9½%
5,000.00	6 months	9½%
10,000.00	3 months	9½%
5,000.00	3 months	9%

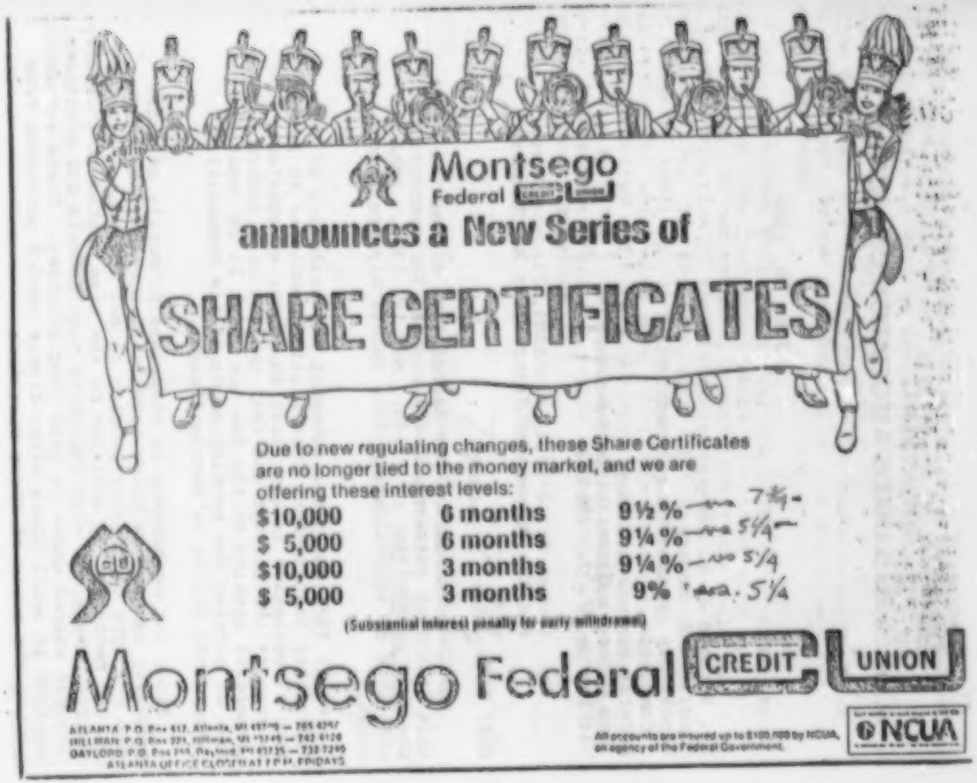
We are a small, independent, community-owned bank with deposits of approximately $10 million. Since this advertisement appeared in our local paper, we can definitely account for in excess of a quarter of a million dollar loss in deposits to the credit union, which can be documented if necessary. We feel that this is just the tip of the iceberg and as soon as our customers' Money Market Certificates mature, we anticipate the loss of additional deposits. We sincerely feel that 4% differential is an extremely competitive edge. Should you feel it necessary, I would be more than happy to testify in this regard. $50,000 of the funds that we have lost during the last few days are funds that our County Treasurer deposited in the credit union on a maturing certificate of our bank. Our Michigan law now permits municipalities, townships and counties to deposit funds in credit unions.

Should you need any additional information, please do not hesitate to call me.

Sincerely,

J. N. Braddock

J. N. BRADDOCK
President & Chairman of the Board, Hillman State Bank
Vice President, Michigan Association of Community Bankers



Montsego
Federal Credit Union

announces a New Series of

SHARE CERTIFICATES

Due to new regulating changes, these Share Certificates are no longer tied to the money market, and we are offering these interest levels:

$10,000	6 months	9½% — now 7¾ -
$ 5,000	6 months	9¼% — now 5¼ —
$10,000	3 months	9¼% — now 5¼
$ 5,000	3 months	9% now 5¼

(Substantial interest penalty for early withdrawal)

Montsego Federal CREDIT UNION

ATLANTA P.O. Box 417, Atlanta, MI 49709 — 785-4297
HILLMAN P.O. Box 221, Hillman, MI 49746 — 742-4120
GAYLORD P.O. Box 249, Gaylord, MI 49735 — 732-7249
ATLANTA OFFICE CLOSED AT 2 P.M. FRIDAYS

All accounts are insured up to $100,000 by NCUA, an agency of the Federal Government.

NCUA

Independent
BANKERS ASSOCIATION OF AMERICA

June 30, 1980

Mr. Normand R. V. Bernard
Executive Secretary
Depository Institutions Deregulation
  Committee
Federal Reserve Building
20th Street & Constitution Avenue, N.W.
Washington, D. C. 20551

Re: Docket No. D-0004, Premiums, Finders Fees, and the Payment of Interest in Merchandise

Dear Sir:

The Independent Bankers Association of America files this statement pursuant to the request for comments in the Federal Register of Friday, May 16, 1980. IBAA is comprised of approximately 7300 relatively small community banks.

While IBAA questions somewhat the authority of the Depository Institutions Deregulation Committee to issue such a regulation in the first instance; nonetheless, we support the concept and feel that it will return commercial banking to the job for which it is created--that of serving the banking needs of its communities rather than acting as merchandisers.

Since our membership is comprised primarily of small community banks, the heavy accounting burden associated with any type of premium program causes additional problems for our members. In addition to the time wasted on inventory control, there are also reporting requirements for additional interest earned under certain circumstances. These accounting problems in small banks often divert needed personnel from serving the needs of their customers.

Additionally, with the elimination by banks of premiums
d the conversion to an all cash system without finder's
es, the customer will be better able to determine the
act benefits he is receiving from his savings certificates
d accounts. With today's complex premium schemes, it is
ten difficult for the consumer to determine exactly which
the savings program most beneficial for his or her
rticular needs.

In conclusion, while some feel the offering of premiums
y be one way for commercial banks to compete with thrift
stitutions, in our opinion, a much better way would be
quick elimination of the discriminatory differential
ere possible. The banking public will be better served
financial institutions concentrate on those types of
sinesses for which they were chartered--channeling their
lents to better and more innovative financial services
ther than spending time handling various premium promotions.
the long run, the general public will probably receive
tter financial services.

Sincerely,

Thomas F. Bolger

Thomas F. Bolger
President

President
THOMAS F. BOLGER, President
McHenry State Bank
McHenry, Illinois 60050

First Vice President
W. C. BENNETT, Chief Executive Officer
Arthur State Bank
Union, South Carolina 29379

Independent
BANKERS ASSOCIATION OF AMERICA

OFFICE OF THE
PRESIDENT

3510 WEST ELM STREET, McHENRY, ILLINOIS 60050

August 4, 1980

Honorable William Proxmire, Chairman
Committee on Banking, Housing
& Urban Affairs
5241 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Proxmire:

Thank you for your kind invitation to testify on August 5, 1980 with regard to actions taken to date by the Depository Institutions Deregulation Committee (DIDC) and also on S. 2927 which would prescribe an interest-rate differential on deposits and accounts in insured banks and savings institutions. Your staff has agreed to our submitting our views in writing and our position on these important matters follows.

The Independent Bankers Association of America, representing 7300 small to medium sized commercial banks throughout the country, is vitally interested in the work of the DIDC and is following its deliberations closely. We are also following the practice of making our views known to DIDC on the important issues they are dealing with--issues which will affect the competitive position and even the viability of our member's banks in the months and years ahead.

For example, and most germane to the subject of the hearings on August 5, I wrote the President on June 18, 1980 expressing our views on the actions of DIDC as regards the differential on six-month certificates of deposit. In that letter (copy attached), we stated that the Committee did not go far enough in removing the differential and should have, at the very least, signalled that the differential on this very popular instrument would be eliminated next January 1, when the thrifts will be able to offer most forms of transaction accounts nationally. We noted further that the Committee must take action looking towards giving commercial banks an equal opportunity to compete for deposits needed to meet the credit needs of their communities for housing, for small business and for agriculture. It is an often overlooked fact that small banks are heavily involved in housing finance. For example, more than one-third of the total loans of banks under $50 million were supported by real estate in 1978.

We have also written DIDC supporting the proposed limitation on premiums (copy of letter attached) and have contacted it concerning certain instances where credit unions are offering savings instruments in such a manner that commercial banks and savings and loans have little chance of competing (copy of letter attached). We realize DIDC has no direct jurisdiction over credit union rates, but we do believe it can and should find means of promoting the policy of competitive parity annunciated by the Depository Institutions Deregulation and Monetary Control Act of 1980. For instance, many credit unions, despite the efforts of the National Credit Union Administration, continue to advertise a 7% rate on share drafts but fail to mention in their advertisements that this rate is calculated against the low balance of principal in the account over an extended period of time. It appears to us that DIDC could refer this problem to the Financial Institutions Examination Council, the membership of which largely overlaps with that of DIDC, for review and appropriate curative action.

In accordance with the above comments, the Association is opposed to S. 2927, introduced by Senator Morgan on July 2, 1980, which would statutorily phase out differentials between commercial bank rates and thrift rates over a six-year period. Again, the Depository Institutions Deregulation and Monetary Control Act of 1980, P.L. 96-221, clearly set out a policy of competitive parity which should be implemented promptly.

In conclusion, savings and loans, commercial banks, mutual savings banks, credit unions and all their respective regulators are now engaged in the making of those many changes which are necessary to provide for competitive parity among financial institutions. S. 2927 would needlessly fetter this entire process by removing its keystone--the power of DIDC to move the whole depository rate structure toward the equality of an open market.

Your consideration of our comments is greatly appreciated. We would hope that this letter and its attachments can be included in the hearing record.

Sincerely,

Thomas F. Bolger

Thomas F. Bolger
President

TFB/nls

Enclosures (3)

cc: Senator Jake Garn

THE USE OF PREMIUMS BY DEPOSITORY INSTITUTIONS:

Impact on Financial Institutions, on Consumers and on the Bank Premium Industry

A Study for the

Premium Coordinating Committee

July, 1980

Collado Associates, Inc.
1625 Eye Street, N.W.
Washington, D.C. 20006

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MAJOR FINDINGS

This study examines the effects that merchandise premium usage has had on financial institutions, bank customers and premium companies. The report concludes that premiums, on balance, have proved to be an effective promotional supplement for financial institutions to use to attain a variety of deposit-seeking objectives. Premiums offer bank customers economic benefits that they could not obtain without them. And the premium companies constitute a substantial industry providing valuable services to institutions and depositors alike.

In view of the advantages stemming from merchandise premiums, Federal financial regulatory agencies should make a strong showing that such premiums are otherwise harmful before implementing their proposed ban on the use of premiums or gifts by depository institutions.

Effect on Depository Institutions

(1) The use of merchandise premiums is not limited to a single market such as New York City, but is spread consistently throughout most market territories in the United States. An independent survey of merchandise premium usage by banks and S&L's shows that they used approximately $348.3-352.3 million in premiums in 1979. (Page 22.)

(2) From a second perspective, premium companies sold an estimated $403.8 million in merchandise premiums to depository institutions. (Page 23.)

(3) Merchandise premium programs successfully generate deposits. (Pages 32 & 33.) Two sets of calculations are used to determine the volume of deposits nationally flowing from premium promotions. The volume is projected to be $78.3 billion to $132.1 billion. (Pages 27-28.)

(4) Premium-generated deposits were found to be a cost-effective alternative marketing tool when compared to non-premium funds. The cost of premium merchandise in a composite sample program is estimated to be $0.80 per $1000 of deposits. Including media costs and other incidentals, that cost is $3.60 per $1000, compared to $5.45 per $1000 for non-premium deposits. (Page 35.)

(5) Available data show that premium and non-premium demand deposits reflect comparable retention levels at banks after 6-months, that time deposits show a somewhat lower rate among premium deposits, and that the changes in account balances over time for premium and non-premium deposits show no statistically significant deviations. (Page 37.)

Effects on Consumers

As long as Regulation Q stands, and interest rates are constrained by it, bank premiums offer the consumer a benefit and an inducement to save that cannot readily be replaced if premiums were prohibited as the DIDC proposes.

(1) Beyond the simple acquisition of a free gift, the consumer is able to benefit from the purchase of premiums at deep discount. To be effective, bank premium vendors and banks must offer reduced-price premiums at a price substantially below the "low retail cost" of similar goods. (Page 48.)

Bank Premium Industry

(1) A survey shows that there are 106 major premium companies that sold $403.8 million in merchandise premiums to financial institutions in 1979. (Page 54.)

(2) Although the largest market for these sales was the New York-New Jersey region with $118.7 million in sales and with 11 premium companies (Pages 23 & 55.), the survey shows a nationwide distribution pattern for both sales (Pages 22-23) and companies (Page 55).

(3) The top 20 premium companies employ approximately 585 workers and the remainder may account for an additional 500-600 employees.

Industry sources estimate that approximately 50,000 U.S. manufacturing jobs may be supported by bank premium sales. (Pages 56-57.)

(4) The bulk of bank premiums are sold by companies that specialize in such sales. Survey data show that 44 percent of premium companies (43 of 98 reporting detailed sales information) derived more than 75 percent of their business from bank premium sales while those companies accounted for 72 percent ($268.4 million of $373.8 million sales for which data were available) of the sales to banks and S&L's. (Page 56.) Many of these companies and their employees would be injured if bank premiums were banned.

Background

Purpose of Study

The Depository Institutions Deregulation and Monetary Control Act of 1980 (Pub.Law 96-221) established the Depository Institutions Deregulation Committee (DIDC) to monitor the deregulation of financial interest rate ceilings and other Federal controls over depository institutions.

At a May 6, 1980, meeting, the DIDC voted to propose new rules to:

- -- prohibit financial institutions from giving depositors a premium or gift (whether in the form of cash or merchandise);
- -- treat finders fees paid to third parties as the payment of interest to the depositor; and
- -- limit such finders fees to cash payments.

In its notice of proposed rulemaking,the DIDC expressed concern about "possible circumvention of interest rate limitations through the use of premiums -- and finders fees." The Committee stated that such programs require Federal financial agencies to spend a substantial amount of examiner time investigating complaints and reviewing compliance.

This study was commissioned by the Premium Coordinating Committee, composed of manufacturers and vendors of bank premium merchandise, in response to the proposed rules of the DIDC. Its purpose is to look beyond questions of enforcement -- for almost all markets and activities that are the subject of government regulation entail some form of compliance problems -- to the greater issue of effectiveness. Is premium merchandise an effective and efficient means of attracting deposits to financial institutions?

That question is particularly important at this time when the U.S. rate of savings has dropped to a record low level and when Executive Branch and independent regulatory agencies alike have become disturbed by continued U.S. public emphasis on consumption rather than savings. At a time when every effort is being made to seek ways to stimulate new savings and investments, it is vital that Federal financial regulators determine whether premium programs represent an effective and helpful tool that depository institutions can use to encourage savings and attract deposits. If such programs are found to be of assistance with respect to that important objective, the agencies will certainly be able to find the means to improve their regulation without stifling their contributions to the U.S. economy.

Organization

This study attempts to analyze several aspects of bank premium programs in an effort to evaluate their effectiveness in raising deposits. The results of the analysis are presented in this report, which has been divided into three sections to examine the effects of premiums first on financial institutions, then on bank customers and finally on the bank premium industry.

Section One

In order to comprehend the effects of premiums on the U.S. financial community, it is first helpful to understand the dimensions of their use. Are bank premiums, as some critics have charged, some form of colussus that pervades such localized markets as New York City and is all but absent from the rest of the banking system? Or are premiums used nationally as one of several marketing tools available to institutions seeking to attract deposits?

The report looks at available data to estimate the magnitude of the bank premium market from two perspectives: use of premiums by banks and sales to depository institutions by premium vendors. In an effort to develop independent data within the very brief time provided by the DIDC for public comment, Collado Associates conducted a survey of financial institutions and premium vendors in 18 market territories embracing the 50 states. Given the time constraints of the DIDC's July 16, 1980, deadline for comments, Collado Associates used a network of correspondent vendors similar to, but somewhat more extensive than, a network developed by Howard A. Rubin of U.S. Financial Services Inc. to estimate for the DIDC total premium usage by financial institutions.[1] (Details of the Collado Associates survey are discussed below.)

The report next examines preliminary methods of projecting the volume of bank deposits that are generated by merchandise premium campaigns. It identifies average unit values for a variety of premium categories and, using the data for estimated total merchandise premium usage, the approximate number of deposits generated annually from premium programs. Using values for average premium-related deposits, derived from interviews with financial institutions and premium vendors, the report calculates an estimate of the total volume of deposits generated by premiums.

It is one thing to know the volume of premium-derived deposits and another to know whether premiums are a cost-effective method to generate such deposits. Using a sample premium program which is in reality a composite of more than a dozen programs studied, the report reviews the ability of premiums to generate deposits in comparison with deposits generated during non-premium periods. The effectiveness of both premium and non-premium promotional campaigns is examined in terms of the cost to generate $1000 of deposits and the overall cost of new bank accounts.

Finally, the report studies retention rates and account balance changes for premium and non-premium deposits to determine whether or not premium programs generate deposits that on the average remain at a depository institution in sufficient quantity to be of value to the institution. Moreover, the report evaluates available data with respect to the generation of new deposits, rather than the recycling of existing money, through premium campaigns.

Section Two

The study next examines whether or not bank premiums are a benefit to consumers who are attracted to the institutions that use them. The report analyzes a variety of pricing systems for merchandise premiums and compares these with alternative wholesale and retail markup procedures. In this context, different and progressive stages in the price cycle of products are analyzed to show the manner in which markups occur and areas from which potential and actual consumer benefits may be derived.

Section Three

The report turns to the companies that sell and distribute merchandise premiums to financial institutions. Based on the results of the Collado Associates survey (described below), estimates are made of the number of bank premium vendors actively selling merchandise, their size and volume of sales and the degree to which their sales are concentrated in bank premium sales rather than diversified across a broad spectrum of markets.

Methodology

Collado Associates reviewed the existing data and literature regarding bank premiums. Confronted with a paucity of sound information, we embarked on a series of interviews with banks and S&L's that use premiums to determine why they used merchandise in their marketing operations and what their experiences had been with premium campaigns. These interviews by no means reflect an exhaustive sampling of financial institutions having experience with premiums. Indeed, every institution approached reflected some form of favorable attitude toward such programs and none was, on balance, adversely critical of them.

In order to come to grips with the dimensions of the bank premium market, Collado Associates conducted a survey of bank premium usage and premium vendor sales. The survey sought to learn the size of the market both in terms of bank purchases of merchandise premiums and sales of such premiums to financial institutions by vendors. These figures should be identical; however, the survey used two different approaches to arrive at the totals and, as a result, generated two slightly different, although complimentary numbers that reflect an estimated range for the market's size. In doing so, the survey produced estimates of the number of major bank premium users, the number of bank premium vendors selling more than $50,000 of merchandise to financial institutions in 1979, and the proportion of companies slightly and heavily engaged in the bank premium market.

The survey employed a network of correspondents from various geographical regions covering all 50 states. Many of these correspondents were those used in the abovementioned survey by Howard A. Rubin of U.S. Financial Services. All were premium vendors familiar with a particular territory. As was the case with the Rubin survey, 18 territories were identified:

(1) California, Alaska, Washington, Oregon, Hawaii, Idaho, Montana, Wyoming, Utah, Arizona, New Mexico and Nevada
(2) Colorado
(3) Texas and Oklahoma
(4) Kansas, Nebraska and Missouri
(5) Minnesota, North Dakota and South Dakota
(6) Wisconsin
(7) Illinois and Iowa
(8) Indiana and Kentucky
(9) Michigan
(10) Ohio and West Virginia
(11) Louisiana and Arkansas
(12) Tennessee
(13) Alabama and Mississippi
(14) Florida and Georgia
(15) Virginia, North Carolina and South Carolina
(16) Pennsylvania, Maryland, Delaware and the District of Columbia
(17) New York and New Jersey
(18) Maine, Vermont, New Hampshire, Massachusetts, Rhode Island and Connecticut

Correspondents in these territories were asked to
ntify commercial banks, S&L's and, where appropriate,
ings banks that used merchandise premiums in 1979. They
e asked to group these institutions into dollar-usage
nges -- "under $100,000," "$100,000-$200,000,""$200,000-
00,000," "$500,000-$1,000,000" and "over $1,000,000."
e number of banks and S&L's in each range is shown in the
port.

Similarly, correspondents were asked to list (1) all
jor vendors in their territory, (2) their volume of bank
emium sales in 1979, and (3) the proportion to total 1979
les of their bank premium sales. Correspondents were
utioned to count only vendors based or headquartered in
eir particular territory and to count only final mer-
handise premium sales to institutions. Sales to other
endors or parties were to be excluded. So-called "ad
pecialty" and "Christmas Club" premium sales were excluded
rom the survey. Vendor and sales data were grouped (1)
y dollar volume and (2) by bank premium sales as a per-
entage of total sales for 1979.

All data were grouped into categories by correspond-
nts who canvassed their territories themselves. In most
cases, this method was the only means to obtain trade-
sensitive data from financial institutions and vendors.
The aggregated figures were collected by Collado Associates
and/or Ms. Diane Prange of U.S. Financial Services. This
approach, given the severely limited time available to

Collado Associates, was acceptable, if not by any means ideal; and the results appear to reflect a valid approximation of the dimensions of the bank premium market.

A Primer on Bank Premiums

Why Depository Institutions Use Premiums.

Every banker interviewed for this paper expressed the view that premiums are no substitute for relaxation or removal of ceilings on interest rate ceilings. Nonetheless, marketing vice presidents and financial executives alike insisted that premiums should remain a part of the arsenal of tools that depository institutions may use to attract deposits. One bank president stated that "the only thing worse than premiums is no premiums." These bankers plainly are convinced from their own experience that premiums work and that they attract deposits.

The literature is replete with anecdotal descriptions of bank premium successes. During a three month period in 1966, Lincoln Rochester Trust Company discounted a Kodak Instamatic camera and opened 5,700 new savings accounts. The same bank typically spends 50 to 70 thousand dollars on premium merchandise and media advertising and produces between $3 million and $8 million in new deposit money.[2/] First Pennsylvania Bank of Philadelphia testified that it used bank premiums to attract 30,000 new accounts and $84 million deposits over a three month period in 1974.[3/] More recently, dozens of success stories have appeared in the onthly issues of Incentive Marketing[4] and Premium/Inentive Business[5] and various issues of American Banker, id-Continent Banker, Savings and Loan News, and Financial arketing.

Depository institutions appear to have maintained ver the past dozen years a favorable opinion of bank premium programs. A 1968 ABA study showed that nearly 80 perent of banks and S&L's using premiums had had good or fair success with them.[6] A survey published in February 1980 by Unidex Corp. shows a 96 percent favorable response among 166 institutions employing premium programs, broken down 37 percent "very successful" and 59 percent "moderately successful".[7]

Not surprisingly, the principal objective of a premium program is to increase savings deposits. But premiums are used for a wide variety of goals. The results of the Unidex survey list the following types of promotions used as a percentage of respondents[8]:

	1980	1977
Regular savings deposits	89%	73%
Extended time deposits/ certificates of deposit	70	42
Auto loans	5	20
Other personal loans	9	16
Branch/office openings	49	73
Promote usage of electronic service (e.g. automatic teller machine and point-of-sales)	15	18

Another 1980 study, by Premium/Incentive Business, compares the multiple objectives of commercial banks and savings banks:[9/]

	Commercial Banks (74 replies)	Savings Banks (99 replies)
To obtain new depositors	95.9%	92.9%
To build more traffic	54.1	65.7
To open new office/branch	47.3	72.7
To motivate employees	39.2	14.1
To gain marketing edge	37.8	42.4
As a competitive necessity	25.7	54.5
To generate more loan business	18.2	10.1

The Premium Program

Depository institutions that use premiums tend to use them during relatively brief periods of time in the course of their fiscal year. Moreover, whatever the objective of the promotion, the incentive campaign is almost always conceived and implemented by the depository's advertising or marketing department as an alternative to traditional marketing tools.

Banks and S&L's have two basic ways available to raise funds: through borrowing and through promotions. Promotions can again be divided into (1) advertising the bank's financial services to the public and (2) premium-incentive campaigns. Both kinds of promotions are handled by the institution's advertising and/or marketing departments and both tend to be funded from those departments' budgets.

Of the financial institutions interviewed for this study, all treated premium programs as an "alternative marketing tool to promote the bank's services and to attract new or additional deposits." Moreover, these institutions indicated that they did not operate a separate budget account for premium programs but, rather, drew the necessary funds from their advertising budgets. To emphasize the fact that premium campaigns are regarded merely as alternative forms of media promotion, the depositories interviewed stated that they did not include the cost of advertising in their estimates of the cost of a premium campaign because the same funds would have been used in any event as part of the bank's and S&L's continuing media promotion efforts.

Several bank executives stressed that premium promotions are not a separate phenomenon but, instead, a supplement to normal advertising. They pointed to the fact that most banks run between one and two premium campaigns a year -- 1.7 programs on average among the institutions interviewed -- and that these promotions last on an average eight to 10 weeks, a small portion of the fiscal year. (Savings & Loans tended to run longer and more frequent programs, probably because S&L's view premium programs in part as a defensive step to counterbalance commercial banks' use of such incentives.) Of course, certain kinds of premium programs -- especially the continuity programs described below -- may run for as long as nine to 18 months.

According to Incentive Marketing magazine, commercial banks in their survey expect to use an average of 1.3 premium promotions in 1980, while S&L's plan an average of two such campaigns.[10] The banks and S&L's in the Premium/Incentive Business survey used 2.7 and 3.4 promotions respectively in 1979.[11]

To fund these efforts, P/IB estimates that the average depository in 1979 spent $43,480 (excluding advertising costs). Based on a sample of 168 respondents, the figures were as follows:[12]

Commercial Banks	
Deposits under $100mm	$20,688
Deposits over $100mm	$38,320
Savings Banks	
Deposits under $100mm	$27,492
Deposits over $100mm	$94,549

Different Kinds of Premium Programs

The Federal Reserve Board, Federal Deposit Insurance Corporation, Federal Home Loan Bank Board and National Credit Union Administration currently limit the cost of premiums to $5 for deposits of less than $5,000 and $10 for deposits of $5000 or more. Depository institutions may give such premiums at any time to depositors who open new accounts or add to existing ones. Premiums may not be offered on a recurring basis to the same depositor. There appear to be no regulations specifying maximum values for finders fees or for self-liquidating premium promotions.

As is the case with private enterprise that evolves in a regulated environment, the bank premium business has developed to take maximum advantage of existing Federal and state rules -- much as fish adapt to life in and around a coral reef. Although there are a wide variety of premium programs, they are normally classified as (1) "one-shots", or (2) "continuities". A recent and distinct kind of premium program has evolved in New York City, based on the giving of a "finders fee" to the "sponsor" of a new depositor. While the depositor receives a gift, it is the sponsor who is rewarded with a substantial article of merchandise or, increasingly, a cash gift equivalent to as much as 1%-1.5% of the principal.

The foregoing groupings refer to the manner and frequency in which premiums are given to depositors. Premiums are also distinguished by their cost to the depositor. They may be free gifts (give-aways) or self-liquidators which involve either partial or full payment by the depositor at discounted prices.

One-shot programs. Until recently, the bulk of one-shot premiums were free gifts, given to the depositor at the time he or she opens an account or in some other manner meets the institution's requirements. There are no subsequent premiums in the program -- thus the term "one-shot". The cost to the depository of the give-away premium must not exceed the Federal ceilings and the institution absorbs that cost as the expense of the promotion program. One-shots embrace sweepstakes, and specialty promotions and similar give-aways.

As inflation has eroded the value of a premium that can meet the $5 and $10 cost ceilings (the consumer price index had risen to 186.9 at the end of 1979 (1970=100)), institutions have switched in increasing numbers to so-called self-liquidating premium programs. These allow the bank or S&L to offer more attractive merchandise and, at the same time, to control better the cost to themselves of the promotion program. As long as the spread between the cost of the goods to the bank or S&L and the cost to the depositor (assuming it is less) does not exceed the $5 and $10 ceilings, there is no current limit on the value of the merchandise that can be used in a self-liquidating program.

In spite of the rapid growth of self-liquidators in the 1970s, one-shot give-aways continue to predominate in larger metropolitan areas such as New York City and, more generally, in urban areas with more than 200,000 in population.[13] They are also selected more frequently among "thrift" marketers and larger financial institutions.

Continuity programs. In a continuity program, a customer is given a free premium at the time of his or her first deposit. That single gift, typically a setting of dinnerware, a piece of crystalware or an item of flatware, is assumed to be of little value to the depositor. However, by making additional deposits within the period of the promotion, the customer is able to purchase at a discounted price additional components of a set that assumes real value to the depositor as the set grows.

Continuity programs are self-liquidating as the bank recoups the cost of the initial free gift, in whole or in part, through subsequent purchases which are made at bargain prices to the customer but which are slightly higher than the cost to the bank.

Plainly, continuity programs are designed to attract relatively small discrete deposits which accumulate over time as the customer makes additional deposits and builds up his set of premium merchandise. Unlike one-shot promotions which rarely last more than 12 weeks, continuity programs typically extend from nine months to 18 months in order to permit a customer to accumulate a sizable set of premium goods.

Continuities are designed to attract deposits in passbook savings accounts where interest rates are currently limited to 5.25 percent and 5.50 percent respectively for banks and S&L's. They were popular in the 1960s when inflation rates were low and alternative investments for small savers were scarce. With the advent of sustained high inflation and money market certificates, continuity programs have dwindled, although institutions continue to welcome them because they offer a source of "inexpensive" deposits.

I. Depository Institutions and Their Experience With Premiums

The Size of the Bank Premium Market

Incentive Marketing has estimated that $7.6 billion was spent by users of premiums in 1979.[14] Of that total, approximately $166 million was spent by banks and other depository institutions.[15] With 2.2 percent of the total premium-expenditure market, banks and S&L's rank ninth among the largest users of premiums, behind food products, retail grocery and other industries.

However, when attention is directed to consumer premium incentives where depository institutions concentrate their promotional efforts, banks and S&L's rank third (albeit a distant third) with $122.6 million in expenditures in 1978 out of a total of $2.0 billion, or 6.1 percent of that sub-market.[16] Moreover, among the six types of consumer incentives identified in the 1978 Incentive Marketing survey -- self-liquidators, direct premiums, free mail-in offers, factory packs, coupon plans, and sweepstakes/contests -- depository institutions ranked first in the direct premium category with $70.0 million of $532.6 million spent (13.1 percent).[17]

A second trade journal, Premium/Incentive Business, has calculated that total premium and incentive expenditures for 1979 amounted to $162.9.[18] However, that figure represents the responses of only 190 depository institutions or

4 percent of the journal's readership. Premium/Incentive Business projects from that base, apparently without any weighting factor, a grand total of more than $476 million in bank premium expenditures for 1979.[19]

Unfortunately, both the Incentive Marketing and Premium/Incentive Business surveys derive their data from a fairly small sampling of the depository institutions that use premium promotions on a regular or periodic basis. Thus, their calculations are likely to be subject to considerable error (as is evidenced by the range of $166 million to over $476 million in reported bank premium expenditures for 1979). A much more precise figure could be obtained if the 15,171 banks and 4,709 S&L's in the U.S. today were surveyed.

The American Bankers Association attempted such a survey in 1968 and obtained responses from almost 10,000 depository institutions.[20] At the time, the ABA concluded that 27 percent of its respondents had employed premium programs.[21] Interviews conducted by Collado Associates with knowledgable bank officials and bank premium vendors confirm that approximately one in four depository institutions -- or from 4500 to 5000 banks and S&L's -- continue to use premium programs.[22] (This national average obscures the fact that premium-using institutions account for well over 50 percent of the total number of institutions in such areas as Nebraska and New York City, and an even greater percentage as assets, while premiums are used much less frequently in areas such as Texas.)

Obviously, the expenditures by financial institutions is one important measure of the bank premium industry. Another is the volume of sales of premium merchandise as determined by the gross cost of the merchandise to the depository institutions. One would anticipate that the volume of total sales would exceed the expenditures by banks by a considerable margin in view of the fact that a significant proportion of bank premiums are made available to depositors on a self-liquidating basis -- that is, they are sold to the depositor at a deep discount that permits the financial institution to recover much, if not all, of its initial cost of merchandise. Industry experts contacted by us agree that approximately 33-40 percent of bank premiums are handled on a self-liquidating basis. Moreover, the average net cost to banks and S&L's of self-liquidating premiums normally ranges from one-fifth to one-third of the value of the merchandise sold to the banks.

Thus, it would be reasonable to obtain figures for total bank premium sales that ranged anywhere from 1.7 (3 x 0.33 + 0.67) times to 2.6 (5 x 0.4 + 0.6) times as great as the figure for net premium expenditures by banks.

On behalf of the Premium Coordinating Committee, Howard Rubin, President of U.S. Financial Services, Inc., a leading bank premium vendor, calculated that financial institutions purchased in 1979 $381 million in merchandise.[23/]

Rubin arrived at this figure by questioning bank premium vendors located in 18 major market territories encompassing all 50 states. From his survey, he found that an estimated gross volume of $335 million in premiums had been purchased by financial institutions in 1979, and that approximately $427 million had been sold by premium vendors to banks and S&L's. Rubin split the difference between these two estimates, reasoning that the vendors who provided the information for the survey would likely understate the volume of premium usage by banks to which they did not sell and, at the same time, exaggerate the size of the vendors' own businesses.

While sales to banks and cost to banks should theoretically be the same, the Rubin data provide a helpful range to evaluate bank premium sales in 1979. Interestingly, the numbers he develops fall within the scope of plausibility for bank premium usage based on the aforementioned multiplier factors (1.7-2.6) to adjust net costs of premiums to banks to account for self-liquidating premium use. Using those factors, the $166 million cost estimate used by Incentive Marketing would become a range of $282 million to $432 million in bank premium sales.[24/]

Because of severe time constraints imposed by the July 16 deadline for comments to the Depository Institutions Deregulation Committee, Collado Associates was unable to confirm the Rubin data by means of an independent survey of major manufacturing suppliers of bank premium merchandise. Instead, the firm elected to retrace Rubin's steps, seeking to obtain data in greater detail from the 18 market territories used by Rubin.

Key vendors were contacted in each territory and were asked to re-evaluate their premium usage data. The contact vendors were asked to develop lists of all the banks and S&L's in the 18 territories and the premium usage in 1979 of each. To protect potentially trade sensitive information, the individual financial institutions were grouped by volume of usage into five dollar-range categories, separating banks and S&L's in each instance.

Table 1 shows the aggregate results of this portion of our survey.

Table 1

1979 Bank Premium Usage, By
Financial Institution
(No.Institutions)

Usage Range	Commercial Banks	Savings & Loans	Total
Under $100,000	1058	617-632	1675-1690
$100,000-$199,999	323-333	314-329	637-662
$200,000-$499,999	93-94	155-160	248-254
$500,000-$999,000	26-31	38-39	64-70
$1,000,000 and over	16-17	20	36-37
TOTALS	1516-1533	1144-1180	2758-2811[1]

[1] Grand total of 2758-2811 institutions included 47 Virginia and 51 New York institutions not included in usage subtotals because of unavailability of breakdown for those states at time of publication.

SOURCE: Collado Associates survey.

The survey identified a total of 2758-2811 major
inancial institutions that regularly or periodically use
erchandise premiums. Approximately 60 percent of these
ere banks and S&L's that spent under $100,000 for prem-
ums in 1979. A little less than 25 percent of the insti-
utions spent between $100,000 and $200,000 for premiums,
hile nine percent spent $200,000 to $500,000, three per-
ent spent $500,000 to $1 million and 1.5 percent spent
ore than $1 million.

The data in Table 1 show that S&L's tend to spend
ore on premiums than their bank counterparts. Nearly 70
ercent of the surveyed banks were grouped in the under
$100,000 range compared to 55 percent of the S&L's. But
28 percent of S&L's spent $100,000 to $200,000 in contrast
to 21 percent of the banks; 13 percent of the S&L's spent
$200,000 to $500,000 while only six percent of the banks
spent that much. The comparisons for the $500,000 to $1
million and over $1 million ranges were approximately two-
to-one in favor of S&L's. (See Table A-2, Appendix A,
for a breakdown of bank premium usage by territories.)

The survey results show that these financial institutions accounted for $348.3-$352.3 million in merchandise premium purchases in 1979. (For details, see Table A-1, Appendix A.) Institutions used premiums in each of the 18 territories defined in the study, ranging from a low of $700,000 in Oklahoma and Texas to a high of $118.7 million in New York and New Jersey. Aside from the latter territory, other major users of merchandise premiums were located in Illinois and Iowa ($60 million), New England ($20 million), Pennsylvania, Maryland and Delaware ($24-25 million), the Far West ($25.5 million) and Minnesota ($12.8 million).

The New York-New Jersey area is of unusual interest because of its large volume of merchandise premium usage. Table A-3, Appendix portrays the distribution of banks and their range of usage. Of the 215 banks and S&L's identified in that region as being premium users, 63 are located in New York City and Long Island, 51 in the rest of New York state and 101 in New Jersey. Of the 63 New York City institutions, 9 are commercial banks, 34 are savings banks and 20 are S&L's. Of the 101 New Jersey institutions, 45 are commercial banks, 14 savings banks and 42 S&L's.[25/]

New York City banks and S&L's are estimated to have spent $90 million in 1979 for merchandise premiums. Banks in the rest of the state spent approximately $12 million more for a total of $102 million, while New Jersey accounted for another $16.7 million.

One way to cross-check the national figures for bank premium usage is to estimate sales of merchandise premiums to banks by vendors. Using the network of vendor correspondents in the 18 territories, the survey determined that $403.8 million was sold to financial institutions in 1979. (See Table B-1, Appendix B for details.)

From the perspective of premium sales to banks, the $403.8 million is spread even more homogeneously across the nation. The New York-New Jersey territory still reflects the largest volume of sales by vendors in the same territory ($85 million). However, Pennsylvania, Maryland and Delaware come in a close second ($71.1 million), while Illinois and Iowa reported $69.0 million in vendor sales.

In theory, the $348.3-$352.3 million estimate for merchandise premium purchases by banks should equal the $403.8 million estimate for premium sales by vendors. The differential may be explained by several factors: (1) the Collado Associates survey was an incomplete sampling of financial institutions and premium vendors; (2) estimates for each were derived by separate calculations which were in turn based often on "best-guess" projections; (3) there may have been definitional problems that caused undercounting or overcounting in certain areas; and (4) errors of human judgment may have caused the survey correspondents to exaggerate vendor sales and understate purchases by banks.

Nonetheless, the two figures can serve as a useful guideline to demarcate the dimensions of the bank premium market. Until a major new survey is conducted, it is reasonable to estimate that this market comprised approximately $348.3 million to $403.8 million in merchandise premiums in 1979.

These sales figures should be viewed in relation to other data involving merchandise shipping and handling expenses and the costs of promotional advertising. Rubin has estimated that in 1979 there was approximately $21 million in freight revenues generated from merchandise shipments from manufacturers to financial institutions, based on a cost equal to 5.5 percent of the national sales volume of bank premium merchandise. Rubin also estimates the cost of media advertising for bank premium promotions at $200-$400 million.[26/] With no hard data available, it is impossible to evaluate these estimates. However, it must be observed that bank marketing departments, which normally handle premium programs, insist that their advertising budgets would be used even if there were no premium campaigns. Thus, there would appear to be no incremental revenues generated from premium-related advertising.

Premium Deposit Volume

The survey was unable to determine with any precision the portion of total premium usage that was accounted for by the major classes of merchandise program. Nonetheless, in the course of the study, we interviewed bank executives and major premium vendors and obtained the following data:

One-shot programs -- $270-275 million
Continuity programs -- $58 million
Finders fees programs -- $70-75 million
Total program sales -- $403.8 million

From these figures, and knowing the average cost per unit of the three kinds of premiums coupled with the average deposit associated with each program, it would be possible to derive a general estimate of the volume of deposits generated by 1979 bank premium programs.

Banks and premium vendors have learned from experience to project anticipated deposit inflows as part of their planning for promotional programs. The most common calculations, derived from bank interviews, follow:

One-shots -- No.accts.(savers customer base) x 0.0075 x duration of program (weeks) x avg.deposit = volume of promotion deposits.

Continuities -- No.accts.(savers customer base) x 0.25 x avg.deposit x avg.no. deposits = volume of promotion deposits.

Both the banks interviewed for this study and major premium vendors indicated to us that the bank premium industry bases its premium planning on certain assumptions about average deposits, average program duration and average number of new accounts. These assumptions are based on previous experience with premium programs. (Interestingly, these experiences appear to have been fairly uniform among our industry contacts as they used much the same assumptions.)

Based on these assumptions, the average duration of a one-shot program is eight to ten weeks and, until recently, the average deposit generated from a promotional campaign has been $3000. (The average deposit has reportedly grown to approximately $5000-$6000 during the past six months of high interest rates.) Thus a typical one-shot campaign, assuming an institutional saver-base for a moderate-sized bank or S&L of 50,000 accounts, would generate $9 million in deposits.

(50,000 x 3000 x 8 weeks x 0.0075 = $9 million)

Similarly, the average continuity program lasts for nine to 15 months and generates an average of three separate deposits of $400 each. Thus a 50,000 account institution would obtain $15 million during the course of a 9-month continuity campaign.

(50,000 x $400 x 3 x 0.25 = $15 million)

An average deposit under a finders-fee program currently ranges from $9,000 to $15,000.

Using the average deposit figures, industry estimates of average unit values for merchandise and the dollar value of merchandise sold for each category of premium program, it is possible to obtain a rough estimate of total deposits generated from premium programs last year.

Table 2

Estimated Premium-Generated Deposits -- 1979

Program	Cost of Merchandise	Average Unit Cost	Average Deposit	Total Deposits Generated
One-shot	$270-275	$7.00-$12.00	$3000	$67.5-$117.9B
Continuity	$58	$4.50-$5.00	$400	$ 4.6-$5.2B
Finders-fee	$70-75	$125.00	$9-15,000	$ 6.2-$9.0B
Total				$78.3-$132.1B

SOURCE: Industry Data.

By using our data for the cost of merchandise and dividing them by the average cost per unit, the approximate number of premium units can be found. Multiplying the number of units by the average deposit, it projects the volume of deposits generated by premiums. This crude estimate is shown in Table 2 as ranging from $78.3 billion to $132.1 billion.

An equally speculative approach to the calculation of total deposits generated from premium programs, based on available information, involves the relationship between net costs of premiums and deposit dollars generated. Although the figure can vary considerably depending on several variables, including interest rates, the money supply and alternative uses of funds, bankers and premium vendors judge from experience that the average cost of premiums is 0.2 percent, or $2 for every $1000 deposited. Thus, if the $166 million total premium cost to banks used by *Incentive Marketing* is correct or approximately so, one could calculate that $83 billion in deposits were raised as a result of premium programs last year.

($166 million ÷ $2 x $100- = $83 billion)

Premium Programs: An Example

The following description of a fairly large-scale one-shot premium program represents a composite of several such campaigns described by bankers using them.

A commercial bank, with several branches in moderately large cities and towns, ran a one-shot program for 10 weeks in the fall of 1979. The program was advertised to attract new savings deposits for the institution and to discourage rollovers of maturing money market certificates and other extended time deposits. The bank offered depositors a variety of electronic digital watches and solid-state calculators as part of a self-liquidating program. Premiums were given to depositors at a discounted price, with the exception of inexpensive items which were available free on a sliding-scale basis to depositors of a minimum of $1000. The program would be judged a "conservative" premium program from the bank's perspective in that the institution's net cost of merchandise was 22.7% of gross costs after partial liquidation. Premiums were bought from a vendor that guaranteed 100 percent return of merchandise rights for defective and unused premiums -- apparently an almost universal practice in the industry today.

Details of the program appear in Table 3.

Table 3

A Sample Premium Program

Number new accounts:	6460
-- Passbook	(2660)
-- 6-mo.MMCs & other	(3800)
Deposits generated:	$37,700,000
-- Passbook (14%)	($5,300,000)
-- 6-mo.MMCs & other (86%)	($32,400,000)
Average deposit:	$ 5,836
-- Passbook	$ 1,992
-- 6-mo.MMCs & other	$ 8,526
Source of deposits:	
-- Checking and savings accounts of bank offering premium	$15,255,000
-- Checks drawn on outside depository institutions	$18,645,000
-- Cash	$ 1,600,000
-- Unknown	$ 2,200,000
Bank expenditures:	
-- Gross cost of premium merchandise	$ 136,400
-- Net cost after partial liquidations	$ 31,000
-- Media advertising[1]	$ 105,000
Distribution of merchandise to branches/administration[1]	- 0 -

The bank does not include these expenses as part of its premium promotion. The media costs are deemed a part of the marketing department's annual budget and, because they would have been spent for other advertising in any event, are not an added cost to the bank. The media costs include costs for banners, lobby displays, statement "stuffers" and teller handouts. Merchandise displays were loaned to the bank by the premium vendor.

The distribution of premiums was handled by the marketing department which used the banks regular courier service to transport premiums to the branch offices and return unused items at the end of the

> campaign. The courier handled premiums only as part of its regular runs among branches. Administration was handled by a management trainee as part of her trainee program at the bank. Although this bank bore no direct distribution costs, some banks, because they are spread over a broad area, bear the expense of warehousing and shipping merchandise to their branches.

SOURCE: Commercial Banks Requesting Confidentiality

Cost Effectiveness of Premium Programs

In Table 4, the sample bank's premium program is compared to its deposit experience during a 10-week non-premium period just prior to the start of advertising for the premium program, a period when deposits were flowing in at what the bank considered a fairly normal, non-premium rate.

Table 4

Sample Premium Program: Deposit Experience During Premium and Non-Premium Periods

	Type of Account		
	Passbook	6-mos.MMCs & Other Savings	Total
Premium program:			
Accounts opened	2660	3800	6460
Deposits	$5.3mm.	$32.4mm.	$37.7mm.
Average deposit	$1992	$8526	$5836
Non-premium period:			
Accounts opened	1865	2390	4255
Deposits	$0.8mm.	$14.6mm.	$15.4mm.
Average deposit	$442	$6112	$3619

SOURCE: Commercial Banks Requesting Confidentiality.

The banks interviewed for this study agreed that premium programs generate new deposits and that they do so at a rate that is greater than standard means of promotion that rely on traditional forms of bank-service advertising. In the example above, over a 10-week period, the bank's premium campaign attracted 6460 new accounts. The bank opened 4255 new accounts in the comparable non-premium period. More striking, the $37.7 million in premium deposits was 145 percent greater than the $15.4 million raised before the campaign. The greatest rate of growth occurred in passbook deposits which increased 563 percent, from $0.8 million during the earlier period to $5.3 million during the premium campaign.

The size of the average deposit also grew, from $3619 in the non-premium period to $5836 during the premium campaign. (It is not clear the extent to which these results were affected by rising interest rates during the periods under consideration. Money market rates ranged from 10% - 11.6% during the non-premium period and 11.7% to 11.85%.)

Another perspective on premium and non-premium deposit rates is afforded in Table 5 which shows the monthly net savings flow for an S&L from January 1979 - February 1980, during which time the association was adversely affected by disintermediation caused by a change in the money market differential. As a result, the S&L ran a five-month self-liquidating one-shot premium program that attracted 18,968 deposits totalling $22.4 million.

Table 5

S&L Premium Program:
Premium and Non-Premium Net Saving Flows

1979:		
January	$ 4,611,901	
February	1,361,774	
March	3,498,682	(Mar.15:MMC Differential Change)
April	(2,070,801)	
May	(980,950)	
June	(3,205,779)	
July	(2,158,354)	
August	(1,900,924)	
September	(500,998)	(Sept.17:Promotion Introduction)
October	7,903,496	
November	5,432,184	
December	3,072,396	
1980:		
January	4,278,066	
February	1,133,573	(Feb.28:Promotion End)

SOURCE: S&L Requesting Confidentiality.

Interviews with financial and marketing executives at banking institutions, show that the effectiveness of any premium program depends on innumerable economic variables but that premium campaigns are consistently capable of increasing an institution's customer savings base by as much as 6 percent to 10 percent over an 8-10 week period. In instances where premiums are used in conjunction with a branch or office opening to attract new accounts, the expansion of the account base obviously can run many times greater.[28/]

The data in Tables 4 and 5 demonstrate that a premium program can increase the number of savings accounts and posits in excess of the rates such deposits would nor-lly accrue. It remains to be seen, though, whether emium programs, with their additional costs of merchandise, e a cost-effective way to raise money for financial insti-tions.

The commercial bank in the example above raised 7.7 million in new deposits with premiums that carried a t cost to the bank of $31,000. (The actual cost of the rchandise was $136,400, $105,400 of which was self-liquidated rough customer purchases at discount.) The bank also spent proximately $105,000 for media expenses, the cost of lobby splays, banners, statement "stuffers" and teller window ndouts. Total costs for the premium program were $136,000. contrast, the costs of advertising for the non-premium riod before the campaign were approximately $84,000 (an timated 80 percent of media costs during the campaign).

The data below summarize the comparative costs per ousand dollars of deposits -- the standard criterion for asuring effectiveness in the industry -- for premium and n-premium periods of time under consideration.

Table 6

Comparative Costs of Premium and Non-Premium Programs

	Premium	Non-Premium
Deposits	$37.7 million	$15.4 million
Costs:		
Merchandise only	$31,000	n.a.
Merchandise & media,etc.	$136,000	$84,000
Cost/$1000 deposit		
Merchandise only	$0.80	n.a.
Merchandise & media,etc.	$3.60	$5.45

SOURCE: Commercial Banks Requesting Confidentiality

Comparing total costs per $1000 of deposits, the premium program cost only $3.60, in contrast to the $5.45 cost for the non-premium period. This cost advantage for premiums as a promotional tool is compounded when one considers the fixed costs of processing and opening an average savings account. According to industry experts, it costs banks approximately $20 in administrative, personnel and computer expenses to open a savings account, regardless of the size of the deposit. Thus, for the average deposit of the premium program, $5836, the deposit-account cost ratio is $292:$1. For the average non-premium deposit, $3619, that ratio is $181:$1.

According to industry experts, efficiencies such as these are obtained nationwide in the U.S., in geographical regions where there is a low concentration of premium users and where the concentration is high. So why does the average bank or S&L not use a premium promotion continuously? Why once or twice a year?

The answer appears to be two-fold. First, bankers feel that the effectiveness of a campaign lies in its being perceived as a "special event" rather than a constant appurtenance to a savings and checking account service. Second, believe that a majority of depositors are not influenced in major part by premiums and that constant promotions would soon become an added cost of doing business rather than a fillip to gain new deposits. This view is borne out by opinion surveys that show only 7.6 percent of a public sampling would definitely consider transferring their account to a premium-using bank while 30.6 percent might consider the transfer and 56.3 percent would not consider it.[29] A similar question asked in 1977 found 11.0 percent of respondents would definitely consider a transfer, 31.5 percent might consider and 54.8 percent would not consider it.[30]

Retention of Deposits

Just as it is important that banks and S&L's acquire new deposits, it is crucial for them to retain them as long as possible. In spite of changes by opponents of premiums that customers engage in premium gamesmanship, shifting their funds from one premium program to another on a periodic basis, banks that use premium programs, and keep records on account retention, claim that premium-generated deposits perform as well as -- if not better than -- non-premium-generated accounts.[31]

The only careful analysis of deposit retention rates was conducted in 1976 at the University of Minnesota Graduate School of Business Administration.[32] Using Chi-square contingency analysis, the study compared premium and non-premium retention rates and account balances at a metropolitan bank and a suburban bank in Minnesota. The results of the study were as follows:

-- New demand deposits opened under a premium program performed as well as similar non-premium deposits during the 6-months following the opening of the new accounts.

-- New time deposits opened during premium campaigns, although showing significantly lower retention rates,[33] perform as well as non-premium accounts on the basis of changes in six-month balances.

-- Customers attracted by premium offers are equally loyal, whether the premium was a free gift or a reduced-price premium.

The Minnesota study confirmed findings that "the number of new (time deposit) accounts opened during premium periods is much greater than in periods when no premium is offered." (Some 75 percent to 100 percent greater.[34]) The study found that initial deposit balances for premium-generated time deposits were similar to those obtained without premiums, a conclusion not in accord with this report's findings based on interviews with depository institutions.[35/] The variance may be explained by the fact that the two kinds of premiums studied by the Minnesota team -- a free gift of cookware and a discounted calculator -- were offered to depositors meeting a minimum deposit threshold, without the now-common inducement of better premiums (or better discounts) for larger deposits.[36/]

Churning v. New Money

Some critics of premiums argue that premiums merely "churn" existing money, moving it from one existing account to another. Proponents of premiums contend that new deposits are created, that funds are shifted from demand deposits to time deposits, that deposits become available for mortgage loans, and that smaller financial institutions need premiums to compete for scarce deposit dollars with larger banks and S&L's.

While there is doubtless merit to both sides of the argument, there are no data to prove which side is on balance correct. The Lincoln Rochester Trust Company, in 1972, found that there were striking differences in the source of funds for premium and non-premium deposits in savings accounts, and concluded that "there is less switching from bank savings accounts with premiums than without them"[37/] It was suggested that the size of the volume of cash (apparently excluding checks) as a source of premium accounts indicated a "greater possibility that new deposits for the banking system are created with premium offers."[38/]

Table 7

SOURCE OF NEW SAVINGS ACCOUNT FUNDS

Source of Funds for New Savings Accounts	Percent of Deposit Dollars Generated from a Premium Offer	Percent of Deposit Dollars Generated from Non-Premium Account Openings
Cash	72%	11%
Checks on accounts from own bank	13%	13%
Savings account withdrawals from own bank	4%	30%
Checks or drafts drawn on other banks, including commercial, mutual savings and savings and loans	7%	35%
All other sources	4%	11%

Source: Larry O. Edwards, Lincoln Rochester Trust Company, 1972

The 72 percent "cash" figure in Table 7 is greatly igher than estimates provided to Collado Associates by anks interviewed for this paper. Perhaps a significant ortion of the gap between premium and non-premium "cash" n Table 7 -- 72% versus 11% -- and the gap between premium nd non-premium "checks or drafts drawn on other banks, tc." -- 7% versus 35% -- can be explained by customers' ithdrawing funds from other sources in the form of cash in rder to avoid any embarrassment at their old banks when hey deposit the money in a premium account at a competitor ank.

Even though it is not clear how much truly new money s attracted to the banking system by premiums, the data resented in this report show that premiums, like interest ates, act as an inducement to save. Moreover, financial nstitutions use premiums in the same manner as they use ther interest and non-interest services to compete with ther institutions for the customers' dollar.

Dr. Sidney Feldman of the Indiana School of Business n 1971 defended the shifting of deposits as a partial re- sult of bank premium promotions:

> "Even if it is assumed that premium offers generate no increase in aggregate savings, it does not necessarily follow that prohibiting premiums will, on balance, benefit the nation. Today's banking system includes many independent units of various sizes. A function of the system, in addition to attracting funds, is to act as an intermediary in

placing funds in most productive uses. As long as the marginal revenues (interest payments to banks) exceed the marginal costs (interest paid by banks and operating costs) banks will compete for deposits, bidding them away from competing uses and competing banks. At any point in time, some banks are willing to pay more because they can channel funds into more productive uses. Such flexibility in the banking system is one of its strengths. Bankers have become proficient in competing for funds from single large holders because competition has dictated and allowed this for many years. Why should they not now become more adept at communicating with a customer? Why should they not begin catering to individuals on a larger scale and thereby be forced to determine the most attractive combination of appeals for them?"[39]

II. The Consumer Effects of Bank Premiums

Background

In 1970, Federal bank regulating agencies codified their position with respect to whether the giving of merchandise premiums by depository institutions constituted the payment of interest. This interpretation (12 C.F.R. 217.147) provided that premiums -- whether given in the form of merchandise, credit or cash -- will be treated as an advertising or promotional expense rather than a payment of interest if (a) the premium is given to the depositor only at the time of the opening of a new account or an addition to an existing account; (b) the premium is not given to any depositor on a recurring basis; and (c) the value of the premium or, in the case of articles of merchandise, the wholesale cost (excluding shipping and packaging costs) does not exceed $5.00, except that the value or wholesale cost may not be more than $10.00 if the amount of the deposit is $5,000 or more.

Subsequently, Federal financial regulatory agencies considered merchandise promotion programs involving the direct sale of goods by the financial institution -- usually at or near the institution's cost -- to depositors opening new accounts or adding deposits to outstanding accounts. In addition, a number of promotional programs were developed involving the use of merchant discount coupons distributed by banks that enable depositors to receive discounts on merchandise purchased by them directly from participating retail stores.

The agencies have determined that these programs involve little or no out-of-pocket payment to the deposit or expense to the bank and thus do not involve the payment of interest. In the direct-sale, self-liquidating program, the institution was found to recoup all or most of its purchase costs from the depositor. In merchant coupon programs, the banks incurred practically no costs and the consumers' benefit was derived directly from the participating merchants.40/

In the 1960's financial institutions began to offer prepaid interest to depositors in the form of merchandise in lieu of cash on longer term deposit accounts. While the Fed and other agencies have permitted member banks to pay interest to depositors at the initial depositing of funds, they have required that the interest be discounted in an amount sufficient to ensure that reinvestment of the prepaid interest would not result in a total interest yield in excess of Regulation Q interest rate ceilings. Under these circumstances, the total cost of the prepaid interest in the form of merchandise cannot exceed the amount of discounted cash interest that could be prepaid to the customer.41/

Finally, the regulatory agencies have reviewed merchandise programs where a bank offers a gift (finders fee) to the person (sponsor) who brings someone else into ne bank with a deposit. Since 1963, the Fed has taken ne position that a payment by a bank of a finders fee o a third party, whether in the form of merchandise or ash, does not constitute a payment of interest unless it s passed on to the depositor. Under certain circumstances, owever, the Fed has stated that the payment of such fees ay be an unusual banking practice subject to Federal isciplinary action. The Fed left to other Federal and tate banking agencies the determination whether finders ee programs were compatible with the banking powers of the inancial institution.[42]

onsumer Benefits

Given the tight regulatory control Federal agencies exert on premium programs and the banks' need to minimize the costs of their premium programs, how can the consumer benefit from premium sales?

In the case of the free gift, the benefit is fairly simple. With interest rates pressed up against the ceilings established under Regulation Q, the consumer receives a minimal benefit in the form of merchandise or credit with a value or wholesale cost of no more than $5.00 for deposits under $5000 and no more than $10.00 for deposits of $5000 or more. There is no evidence that depository institutions reduce their interest payments when they offer their depositors premiums. The premium is a minimal added benefit.

In the case of the discounted gift which the depositor buys at a reduced price, the benefit must be a savings for the customer compared to the price he or she could obtain for identical or comparable goods from a retailer. Perhaps to the chagrin of the depository institutions, such "savings" can no longer be measured in terms of the spread between the cost to the customer and the cost at full retail. The advent of catalogue discount showrooms nationwide has taught the customer that the banks must offer premiums at a level below the lowest retail cost -- that is, generally below the cost of merchandise in the catalogue showroom.

In order to accomplish this, both the banks and the premium vendors, and frequently the manufacturer itself, must contribute to the customers' savings. Clearly, the source of greatest savings is the financial institution offering the premium. The 1968 ABA survey determined that banks and S&L's passed their merchandise along to depositors at or very near cost.[43/] This practice appears to distinguish the financial community from other industries -- such as supermarkets, gas stations or trading stamp programs -- where the cost of the premiums is reflected in higher prices charged to customers for the products sold. As the interest rate is never reduced to compensate for a premium offer, the merchandise promotion clearly benefits the consumer by increasing the real value of the service acquired.[44/]

Self-Liquidating One-Shot Premiums

Most self-liquidating one-shot premium programs today permit a customer to purchase merchandise on a sliding scale so that the larger deposits entitle the customer to merchandise at ever greater discounts (or free in the case of less expensive goods). Table 8 displays the mechanics of such a program.

Table 8

Pricing of Self-Liquidating Premium Program

Product	Vendor's Cost	Cost to Bank	Low Retail Cost	Cost to Bank Customer Depositing: $300	$1000	$5000
Set of 4 - 13 oz. beverage glasses	$ 2.05	$ 2.25	$ 2.49	$ 2.25	Free	Free
6-piece steak knife set	2.68	2.95	3.95	2.95	Free	Free
Kitchen timer	2.68	2.95	3.97	2.95	Free	Free
Milk can with utensils	3.18	3.50	5.97	3.95	$ 2.95	Free
Over-the-sink cutting board	3.59	3.95	5.97	3.95	2.95	Free
8½" gourmet pan	4.09	4.50	5.99	4.50	3.50	Free
Tea kettle	4.50	4.95	5.97	4.50	3.50	Free
Cookbook	4.50	4.95	7.95	6.95	4.95	$ 2.95
Percolator	7.23	7.95	8.97	7.95	5.95	3.95
Step stool	9.95	10.95	12.77	11.95	7.95	4.95
AM-FM cassette recorder	22.68	24.95	39.95	34.95	24.95	14.95
Convection oven	127.21	139.95	149.94	147.95	142.95	129.95

SOURCE: Premium vendor requesting confidentiality

The data in the table reveal several characteristics about self-liquidating programs. First, the bank must offer its merchandise premiums at costs to the consumer that are significantly below the "low retail cost" -- that is, below the price of identical or similar merchandise sold in such high-volume, deep-discount retail outlets as catalogue showrooms. Increasingly, potential depositors are familiar with the bargains available at these outlets and demand extra benefits from financial institutions. That depositors expect to receive substantial discounts from bank premium programs is apparent in the large number of respondents to a Unidex survey who cited a discount of 50 percent or more.45/

Second, the premium vendor, in order to allow the bank to better the low retail price, more often than not must reduce its traditional markup. The high-volume vendor in the example above marked up its products 10 percent. Third, banks absorb the great majority of the traditional retailer's markup and pass on the greatest savings to the consumers depositing the larger amounts.

In both the continuity and one-shot programs, there is a clear economic benefit to the depositor-consumer. Some critics have argued, though, that these benefits are passed on to the customer at the expense of local retail merchants. Industry proponents of premiums have countered that bank premium programs do not harm and may often enhance retail sales in the area.46/ The reasons given for the increase are (1) that premium campaigns trigger consumer demand for the merchandise used in the bank program that is not satisfied during the brief period of time the products are available and (2) the banks "legitamize" the product in the consumer's mind because it is assumed by the consumer that banks only deal in quality merchandise. Premium vendors informed us that retail sales in the market area where a premium promotion takes place increase from 50 percent to 150 percent in the year following the promotion. Vendors cited such manufacturers as American Tourister and Timex as companies that have documented such gains. However, we have been unable to obtain documentation.

III. The Bank Premium Industry

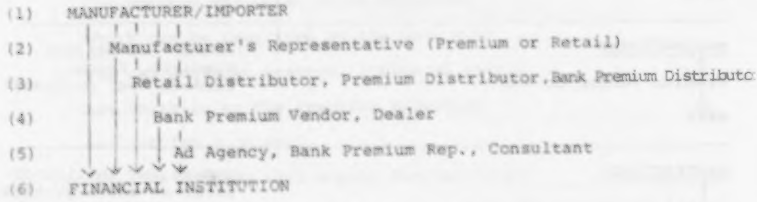
Industry Structure

Approximately 90 percent of the $348.3 million to $403.8 million in merchandise premiums used by banks and S&L's last year was obtained through premium comapnies, according to industry officials interviewed. The remaining 10 percent consisted largely of direct purchases of merchandise by banks from the manufacturer.

Table 9 shows the variety of distribution patterns in the industry. (A glossary of terms appears in Appendix C.)

Table 9

Bank Premiums:Distribution Tiers



(1) MANUFACTURER/IMPORTER
(2) Manufacturer's Representative (Premium or Retail)
(3) Retail Distributor, Premium Distributor,Bank Premium Distributo
(4) Bank Premium Vendor, Dealer
(5) Ad Agency, Bank Premium Rep., Consultant
(6) FINANCIAL INSTITUTION

SOURCE: U.S. Financial Services, Inc.

Table 10 shows several of the most common patterns of distribution.

Table 10

POSSIBLE DISTRIBUTION CHANNELS

MANUFACTURER Manufacturer's Rep (premium or retail) Bank Premium Distributor or Vendor Bank	(most common)
IMPORTER Bank	(very common: continuity programs)
MANUFACTURER Manufacturer's Rep (premium or retail) Premium Distributor (bank or general) Bank Premium Vendor or Rep or Ad Agency Bank	(common for Timex, Corning, Oneida)
MANUFACTURER Premium Vendor or Rep Bank	(common for General Electric, Kodak, "finders fee" programs)
MANUFACTURER Retail Manufacturer's Rep Retail Distributor Bank	(common for in-lieu-of-interest and high-ticket programs)
MANUFACTURER Manufacturer's Premium Rep Premium Distributor Bank Premium Distributor Bank Premium Vendor Ad Agency Bank	(example of long distribution channel)

SOURCE: U.S. Financial Services,Inc.

Bank Premium Company Services

A program is sold to a bank after the bank has examined various suppliers and selected the one whose program, products, and service best suit its needs. This is a highly competitive and often long process, sometimes taking months to finalize. After the promotion has been awarded, a series of services is instituted:

(1) The bank is supplied with advertising materials, copies of ads, brochures, and internal forms for the management and reporting of the campaign. This information is used by the bank to produce its own advertising and other collateral material. The company may offer stock brochures which can be imprinted by the bank with its own personal message; copies of sample ads relating to the specific promotion are available as well.

(2) The company will supply display materials such as lobby displays, teller window displays, and point of purchase materials to the banks. These may be set up by the company.

(3) The company can arrange for individual drop shipment to offices, and local warehousing where necessary, in order to maintain

a constant flow of merchandise availability.

(4) Companies offer educational seminars for tellers and platform personnel in order to explain the nature of the program, and to review the bank's motivation in participating in the campaign.

(5) Finally, companies offer a 100% guaranteed sale, whereby a bank may return for full credit any merchandise which is unused at the end of the program.

Bank premium companies -- whether an individual company which warehouses and distributes its own merchandise, or a sales representative representing a major manufacturer or group of manufacturers in the assembly of a promotional campaign -- always offer these services to their customers. Manufacturers, importers, and companies which supply products to the industry through bank premium companies or sales representatives do not offer any of these services to the banks.

Since banks decide on running promotion campaigns as a result of the delicate nature of the money market, it is almost impossible for them to predict when a campaign will be needed and to order with the appropriate amount of lead time that is normally needed by manufacturers and importers. The premium company's position is one of maintaining inventories and the display and advertising materials mentioned above, in order to have available all of the elements of a successful promotion on short notice.

Industry Demographics

The survey data in Table B-1, Appendix B show that an estimated 106 major vendors -- defined as companies with $50,000 or more in annual bank premium sales -- sold $403.8 million in merchandise to financial institutions in 1979. Table 11 groups these 106 companies in relation to their estimated sales.

Table 11

Major Vendors By Volume of Bank Premium Sales, 1979

Sales Volume	No. Vendors
$ 50,000-$ 99,999	8
$100,000-$499,000	17
$500,000-$999,999	13
$ 1mm - $1.9mm	12
$ 2mm - $4.9mm	24
$ 5mm - $9.9mm	13
$10mm and more	11
TOTAL[1/]	106

[1/] The total includes 8 far west territory vendors not breakdown by sales volume.

SOURCE: Collado Associates survey, June-July, 1980.

The data in the table exclude vendors in Ohio, and three other states which had not replied to the survey at the time of publication. Moreover, the survey did not count branch offices of multi-state firms but only their headquarters. Finally, small vendors or non-bank premium vendors that sell infrequently and in very small amounts to banks were not included in the data. Industry executives estimate that these companies may number more than 100, but account for only a small quantity of bank premium sales beyond the $403.8 million identified.

Vendors are based in all of the market territories identified in Table B-2, Appendix B, ranging from a sole vendor in Oklahoma to 11 in New Jersey and New York, 12 in Minnesota, North Dakota and South Dakota and 14 in Illinois and Iowa. New York and New Jersey have eight vendors with sales of $5 million or more. Seven of those are located in the New York City area -- see Table B-3, Appendix B. Illinois and Iowa have seven vendors in that category.

As part of the investigation, we considered it useful to determine the extent to which the major vendors in our survey were involved in premium and non-premium markets outside of the bank premium market. We asked survey correspondents to poll vendors or, failing that, to estimate the proportion of bank premiums sales as a percentage of total sales in 1979. Table 12 gives the results.

Table 12

Vendor Bank Premium Sales as a Percentage of Total Sales, 1979

Percentage Range	No. Vendors	Sales Volume ($ million)
0% - 25%	35	$ 31.0
26% - 50%	9	20.3
51% - 75%	3	8.8
76% - 100%	43	268.4
% unknown	8	16.3
TOTALS[1]	106	$403.8

[1] Totals do not reconcile with subtotals because data for 3 territories were not available at time of publication. See Table B-4, Appendix B for breakdown by territories.

SOURCE: Collado Associates survey, June-July, 1980.

Forty-four percent of the vendors classified by sales (43 of 98 vendors) had bank premium sales in 1979 that accounted for more than three-fourths of their total sales. At the other end of the scale, 36 percent of the sampling (35 of 98 vendors) sold less than one-fourth of their products and services to banks. The impressive statistic in the table, however, is the huge share of sales volume in the 76-100 percent group. Vendors in this group sold $268.4 million in bank premium merchandise, or 72 percent of the total for bank premiums identified in the survey ($373.8 million).[47]

The survey was unsuccessful in determining the number of jobs throughout the bank premium industry. Interviews with vendors suggest that the largest 20 vendors employ

585 people and that another 500-600 people are employed by the remaining 86 vendors in the industry. The majority of these 1085-1185 U.S. employees apparently work for firms in the 76%-100% category of Table 12.

The bank premium industry must be understood to encompass the U.S. manufacturing companies that produce the merchandise used in premium campaigns by financial institutions. Appendix D lists by geographical area dozens of these companies. Unfortunately, we have not been able to find or develop any hard data to define the economic contribution of U.S. manufacturers to the bank premium industry. Industry sources estimate that approximately 50,000 jobs are directly tied to the industry, but actual data are not available.

The demographic data above portray a highly competitive industry of bank premium vendors whose 1979 sales ranged from $50,000 to well over $30 million. A plurality of these vendors and the great majority of their sales are concentrated in the bank premium market, and not diversified among a variety of markets. The majority of their employees appear to fit this definition as well.

It is not clear how these bank premium vendors and their employees would rebound from a ban on bank premiums without a great deal of difficulty. As we have shown in the first section of this report, bank premiums rank ninth in a $7 billion plus premium industry. It is hard to believe premium markets lie waiting to be tapped if only bank premium vendors can spare the time to tap them. Some vendors would doubtless make the transition if premiums are banned in the banking system. Many would probably fail.

APPENDIX A:

Collado Associates Survey -- Financial Institutions' Use of Bank Premiums in 1979

TABLE A-1

Total Estimated Expenditures For Premiums By Financial Institutions[1] -- 1979

Territory	Collado Associates Survey ($ million)	Rubin[2] Survey ($ million)
No. 1 -- Far West	25.5	25.0
No. 2 -- Colorado	8.2	7.0
No. 3 -- Texas, Okla.	0.7	0.7
No. 4 -- Kans.,Neb.,Mo.	9.3	0.6
No. 5 -- Minn.,N&S Dak.	12.8	15.0
No. 6 -- Wisconsin	7.8	10.0
No. 7 -- Ill.,Iowa	60.0	60.0
No. 8 -- Ind.,Ky.	2.5[3]	2.5
No. 9 -- Michigan	6.2	6.2
No.10 -- Ohio, W.Va.	15.0[3]	15.0
No.11 -- La.,Ark.	4.5[3]	4.5
No.12 -- Tennessee	2.0	3.0
No.13 -- Ala.,Miss.	5.8	5.8
No.14 -- Fla.,Ga.	13.0	13.0
No.15 -- Va.,N&S Car.	12.3-15.3	16.0
No.16 -- Pa.,Md.,Del.,D.C.	24.0-25.0	27.0
No.17 -- N.Y.,N.J.	118.7	99.0
No.18 -- New England	20.0	20.0
TOTAL EXPENDITURES	$348.3-$352.3	$330.3

[1] Based on estimated gross expenditures by depository institutions before redemption through partial liquidations from customer purchases of some premiums at reduced prices.

[2] Based on backup data for Howard A. Rubin letter to Normand R.V. Bernard, DIDC, dated June 17, 1980.

[3] Data not available; based on data from Rubin survey.

SOURCE: Collado Associates survey, June-July 1980.

TABLE A-2

Major Financial Institutions Using Premiums, 1979

Territory	Commercial Banks					Savings & Loans					
	Under $100k	$100k-$200k	$200k-$500k	$500k-$1mm	Over $1mm	Under $100k	$100k-$200k	$200k-$500k	$500k-$1mm	Over $1mm	Total
No. 1 - Far West	120	25	20	10	7	30	10	5	5	3	235
No. 2 - Colorado	8	2	0	0	0	14	2	3	2	4	35
No. 3 - Texas, Okla.	0	4	0	0	0	0	0	0	0	0	4
No. 4 - Kan.,Neb.,Mo.	60	4	0	0	0	40	7	6	4	1	122
No. 5 - Minn.,N.Dak.,S.Dak.	22	4	1	2	0	30	5	0	5 1/	3	72
No. 6 - Wisc.	2/	2/	2/	2/	2/	2/	4/	2/	2/	2/	2/
No. 7 - Ill.,Iowa	572	218	42	1	2	113	189	107	7	5	1256
No. 8 - Ind.,Ky.	2/	2/	2/	2/	2/	2/	2/	2/	2/	2/	2/
No. 9 - Mich.	14	6	0	2	3	6	4	0	1	2	38
No.10 - Ohio,W.Va.	2/	2/	2/	2/	2/	2/	2/	2/	2/	2/	2/
No.11 - La.,Ark.	2/	2/	2/	2/	2/	2/	2/	2/	2/	2/	2/
No.12 - Tenn.	9	0	0	1	0	12	1	2	0	0	25
No.13 - Ala.,Miss.	57	3	3	0	0	18	3	3	0	0	87
No.14 - Fla.,Ga. 3/	40	0 - 10	2 - 3	1 - 6	0 - 1	55-70	22-37	6 - 11	2 - 3	1	129-182
No.15 - Va.,N.Car.,S.Car. 4/	30	3	4	2	1	30	5	2	0	0	124 4/
No.16 - Pa.,Md.,Del.,D.C.	80	11	7	3	2	105	14	9	1	0	232
No.17 - NY,NJ 5/	26	13	10	4	1	64	24	10	11	1	215 5/
No.18 - New England	20	30	4	0	0	100	28	2	0	0	184
TOTAL	1058	323-333	93-94	26-31	16-17	617-632	314-329	155-160	38-39	20	2758-2811 6/

1/ Includes one Minnesota savings bank.

2/ Data not available at time of publication.

3/ Range reflects two differing estimates of bank and S&L usage for Florida.

4/ Breakdown for Virginia not available at time of publication. Total for Territory No. 15 includes Virginia (47 banks & S&Ls).

5/ Data for New York City and New Jersey S&L's include savings banks. (See Table A-3 for breakdown.) Breakdown of banks and S&L's for upstate New York not available at time of publication (total upstate N.Y. = 51 institutions). Total for Territory No. 17 includes 51 upstate N.Y. institutions; sub-totals do not.

6/ Grand total of 2758-2811 institutions includes 47 Virginia institutions and 51 N.Y. institutions not included in usage subtotals because of unavailability of breakdown for those states at time of publication.

SOURCE: Collado Associates survey, June-July, 1980.

TABLE A-3

Major New York and New Jersey Financial Institutions Using Premiums, 1979

Usages	Commercial Banks	Savings Banks	Savings & Loan	Total
ew York City[1]:				
Under $100,000	7	20	14	41
$100-200,000	0	5	4	9
$200-500,000	1	4	0	5
$500-1,000,000	0	5	1	6
Over $1 million	1	0	1	2
Total	9	34	20	63
ew York (Upstate):				
Under $100,000	2/	2/	2/	20
$100-200,000	2/	2/	2/	13
$200-500,000	2/	2/	2/	12
$500-1,000,000	2/	2/	2/	3
Over $1 million	2/	2/	2/	3
Total	2/	2/	2/	51
ew Jersey:				
Under $100,000	19	4	26	49
$100-200,000	13	5	10	28
$200-500,000	9	3	3	15
$500-1,000,000	4	2	3	9
Over $1 million	0	0	0	0
Total	45	14	42	101
RAND TOTALS	n.a.	n.a.	n.a.	215

/ Includes 5 boroughs of N.Y.C. plus Nassau and Suffolk Counties.

/ Data not available at time of publication.

OURCE: Collado Associates survey, June-July, 1980.

APPENDIX B:

Collado Associates Survey --

Bank Premium Vendors

and

1979 Vendor Sales

Table B-1

Bank Premium Sales By Major Vendors,[1] 1979

Territory	Collado Associates Survey Sales ($mm)	Collado Associates Survey No. Vendors	Rubin Survey[2] Sales ($mm)
No. 1 - Far West	$ 30.0[3]	8	30.0
No. 2 - Colorado	7.3	5	1.0
No. 3 - Tex.,Okla.	0.1	1	0.1
No. 4 - Kan.,Neb.,Mo.	12.4	8	15.0
No. 5 - Minn.,N.Dak.,S.Dak.	35.4	12	45.0
No. 6 - Wisc.	8.4	8	6.0
No. 7 - Ill.,Iowa	69.0	14	75.0
No. 8 - Ind.,Ky.	21.2	4	9.0
No. 9 - Mich.	2.9	2	1.5
No.10 - Ohio,W.Va.	20.0[3]	n.a.	20.0
No.11 - La.,Ark.	9.0[3]	n.a.	9.0
No.12 - Tenn.	0.6	3	1.0
No.13 - Ala.,Miss.	3.5	6	3.6
No.14 - Fla.,Ga.	8.3	8	13.0
No.15 - Va.,N.Car.,So.Car.	3.5	3	5.0
No.16 - Pa.,Md.,Del.,D.C.	71.1	7	78.0
No.17 - N.Y.,N.J.	85.0	11	95.0
No.18 - New England	16.1	6	20.0
Totals	$403.8	106	$427.2

[1] Major vendors defined as firms with annual bank premium sales of $50,000 or more. To avoid redundancies, survey counted only vendors based in a particular territory, although maintaining branches in other territories.

[2] Based on data from survey by Howard A. Rubin; see note 10.

[3] Data not available at time of publication; derived from Rubin survey.

SOURCE: Collado Associates survey, June-July, 1980.

TABLE B-2

Major Vendors By Volume of Bank Premium Sales[1], 1979

Territory	$50-99,999	$100-499,999	$500-999,999	$1mm-1.9mm	$2mm-4.9mm	$5mm-9.9mm	$10mm & over	Total
No. 1 - Far West[2]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	8
No. 2 - Colo.	0	0	2	2	1	0	0	5
No. 3 - Texas,Okla.	0	0	1	0	0	0	0	1
No. 4 - Kan.,Neb.,Mo.	0	4	2	0	1	1	0	8
No. 5 - Minn.,N.Dak.,S.Dak.	0	2	1	2	4	2	1	12
No. 6 - Wisc.	1	3	1	1	2	0	0	8
No. 7 - Ill.,Iowa	0	0	0	1	6	5	2	14
No. 8 - Ind.,Ky.	0	1	0	0	2	0	1	4
No. 9 - Mich.	1	0	0	0	1	0	0	2
No.10 - Ohio,W.Va.[2]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
No.11 - La.,Ark.[2]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
No.12 - Tenn.	1	2	0	0	0	0	0	3
No.13 - Ala.,Miss.	3	1	1	0	1	0	0	6
No.14 - Fla.,Ga.	0	4	2	1	0	1	0	8
No.15 - Va.,N.Car.,S.Car.	0	0	1	2	0	0	0	3
No.16 - Pa.,Md.,Del.,D.C.	0	0	1	0	4	0	2	7
No.17 - N.Y.,N.J.	0	0	1	1	1	4	4	11
No.18 - New England	2	0	0	2	1	0	1	6
TOTALS	8	17	13	12	24	13	11	106[3]

[1] Included only vendors actually based or headquartered in a territory. Vendor must be selling directly to a financial institution and be the last firm to handle the product before it sold to the institution. Sales to other vendors not included.

[2] Breakdown and/or totals not available at time of publication.

[3] Because of Far West data, grand total (106 vendors) exceeds subtotals by 8 firms.

SOURCE: Collado Associates survey, June-July, 1980

TABLE B-3

Major Vendors in New York and New Jersey, By Volume of Bank Premium Sales,1979

	$50-99,999	$100-499,999	$500-999,999	$1mm-1.9mm	$2mm-4.9mm	$5mm-9.9mm	$10mm+	Total
New York City[1/]	0	0	1	1	0	3	4	9
New York (rest of state)	0	0	0	0	0	0	0	0
New Jersey	0	0	0	0	1	1	0	2
TOTALS	0	0	1	1	1	4	4	11

[1/] 5 Boroughs plus Nassau and Suffolk Counties.

SOURCE: Collado Associates survey, June-July, 1980.

TABLE B-4

Vendors and Vendor Premium Sales To Financial Institutions

Grouped As Percentage Of Total Sales[1],1979

($million)

Territory	0%-25%		26%-50%		51%-75%		76%-100%		%Unknown[2]		TOTAL	
	Vendor	Sales	Vendor	Sales	Vendor	Sales	Vendor	Sales	Vendor	Sales	Vendor	Sales
No. 1 - Far West[3]	n.a.	$ n.a.	n.a.	$ n.a.	n.a.	$ n.a.	n.a.	$ n.a.	n.a.	$ n.a.	8	$ 30.0
No. 2 - Colo.	0	0.0	1	0.7	1	2.8	3	3.8	0	0.0	5	7.3
No. 3 - Texas,Okla.	0	0.0	1	0.1	0	0.0	0	0.0	0	0.0	1	0.1
No. 4 - Kans.,Neb.,Mo.	3	1.5	1	0.2	0	0.0	2	10.0	2	0.7	8	12.4
No. 5 - Minn.,N.&S.Dak.	3	1.1	2	5.0	2	6.0	5	23.3	0	0.0	12	35.4
No. 6 - Wisc.	6	3.6	1	1.8	0	0.0	1	3.0	0	0.0	8	8.4
No. 7 - Ill.,Iowa	4	8.0	1	6.0	0	0.0	9	55.0	0	0.0	14	69.0
No. 8 - Ind.,Ky.	1	0.1	0	0.0	0	0.0	2	18.6	1	2.5	4	21.2
No. 9 - Mich.	2	2.9	0	0.0	0	0.0	0	0.0	0	0.0	2	2.9
No.10 - Ohio,W.Va.[3]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	20.0
No.11 - La.,Ark.[3]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	9.0
No.12 - Tenn.	3	0.6	0	0.0	0	0.0	0	0.0	0	0.0	3	0.6
No.13 - Ala.,Miss.	3	0.2	0	0.0	0	0.0	2	3.2	1	0.1	6	3.5
No.14 - Fla.,Ga.	5	1.3	0	0.0	0	0.0	3	7.0	0	0.0	8	8.3
No.15 - Va.,N.C.,S.C.	0	0.0	0	0.0	0	0.0	2	3.0	1	0.5	3	3.5
No.16 - Pa.,Md.,Del.,DC	1	0.6	0	0.0	0	0.0	5	68.5	1	2.0	7	71.1
No.17 - N.Y.,N.J.	2	11.0	1	5.0	0	0.0	6	58.5	2	10.5	11	85.0
No.18 - New England	2	0.1	1	1.5	0	0.0	3	14.5	0	0.0	6	16.1
TOTALS	35	$31.0	9	$20.3	3	$ 8.8	43	$268.4	8	$16.3	106[4]	$403.8[4]

[1] Table groups major vendors identified in Collado Associates survey, and their 1979 bank premium sales volume into 5 categories relating to the proportion of 1979 bank premium sales to total bank and non-bank, premium and non-premium sales of the firm for 1979 (expressed as a percentage).

[2] Groups vendors for which data were not available at the time of publication.

[3] Data totals and/or subtotals not available at time of publication. Territory Nos. 10 and 11 total sales were obtained from Howard A. Rubin survey (see reference at note 10).

[4] Percentage subtotals do not add to 106 vendors and $403.8 million sales;see table footnote 3 above.

SOURCE: Collado Associates survey, June-July,1980.

APPENDIX C

VENDOR DEFINITIONS

A. Retail Area

Retail Distributor--one who purchases and warehouses products from a specified list of manufacturers and provides these products to retail outlets. He may also distribute his products directly to a financial institution or to the institution via a premium vendor. He usually sells these products to the institution at quantity "dealer" prices.

Dealer--one who purchases product for retail sale in his own specified outlet or outlets. He may buy from a retail distributor or directly from the manufacturer. He may offer his products to financial institutions at a cost which is less than retail. This practice is most common with larger appliances such as TV sets and microwave ovens.

Catalog Distributor--purchases and warehouses a specified, limited group of goods from a specified, limited group of manufacturers. All of these goods are featured in a catalog. He may also offer these products to financial institutions at a price less than retail.

Factory Distributor--one who purchases and warehouses product from one specific manufacturer and sells them to dealers. This is not a very common practice--in some cases (Zenith) this distributorship is set up by and strictly controlled by the manufacturer. The factory distributor may also offer these products to financial institutions at the same cost he offers them to dealers.

Manufacturer's Retail Representatives (Rep)--sells a limited, specified group of manufacturers' product lines to the retail trade. He is usually commissioned by the manfacturers to have the exclusive right to represent them. Should the manufacturer sell the product directly to a buyer in the territory covered by the rep, the rep will receive commission even if he is not involved in the sale. (However, this is not the case when a manufacturer has specified that a certain client is a "house account.") Where a manufacturer's product line is represented by a retail rep, and no premium rep exists, the retail rep may sell to the premium trade. He may sell directly to a financial institution or to the institution via a bank premium vendor, distributor, or rep.

Manufacturer's Retail Factory Rep--same as above, exept this person has only one manufacturer to represent. He is employed directly by that manufacturer. (This is the case with Regal and West Bend.)

Premiums--in General

Premium Importer--one who imports and warehouses product strictly for resale to the premium trade. Premium importers may sell directly to financial institutions or go through a bank premium vendor or rep.

Premium importers such as Roberts Incentives of Chicago, import lines that are very adaptable to financial institutions but can also be used in other premium fields. Their soft-side luggage, used widely by banks and thrifts, was featured in a large airline/rent-a-car program last year. Dinnerware importers such as Premium Corporation of America will import dishes to be packaged for banks as well as supermarkets.

Premium Distributor--one who purchases and warehouses product from a specified list of manufacturers and provides these products to premium users (anyone from stamp companies to direct mail companies to General Mills). He is a premium generalist and that includes any sales to financial institutions, either directly or through a bank premium rep, vendor or distributor.

Manufacturer's Premium Rep--sells a limited, specified group of manufacturers product lines to the premium trade. He is usually commissioned by the manufacturers to have an exclusive right to represent them. (Please note that manufacturers such as Faribo, Sunbeam, General Electric, do not operate on an exclusive basis--many premium reps have access to their products and commissions at one time.) Should the manufacturer sell the product directly to a buyer in the territory covered by the rep, the rep will receive commission even is he is not involved in the sale. (However, this is not the case when a manufacturer has specified that a certain client is a "house account.") The manufacturer's premium rep may sell directly to a financial institution or to the institution via a bank premium vendor, distributor or rep.

Premium Consultant--is employed directly by the premium user and receives a fee for his services. However, he may also obtain a commission from manufacturers he recommends. He usually purchases financial premiums from a bank premium vendor or distributor. It is important to note that he does not take title to the goods.

Advertising Agency--often works similarly to premium consultants. They do not take title to goods as a rule. Yet, on occasion, you will find an agency who specializes in premium promotions. This agency will by-pass the bank premium vendor or distributor and purchase from the manufacturer's rep.

Incentive Companies, Stamp Companies, Direct Mail Companies--are all involved in selling to specialized premium users.

C. Bank Premiums

Bank Premium Importer--one who imports and warehouses product strictly for resale to financial institutions. They may sell directly to the institution (this is most common) or have their products sold by bank premium distributors, reps, and vendors. They only import premiums appropriate for the financial industry. The most common type is dinnerware which is imported and packaged especially for bank give-aways.

Bank Premium Distributor--purchases and warehouses product from various manufacturers whose wares are appropriate for the bank premium industry. He usually sells his products directly to the institutions.

Some bank premium distributors will purchase both products for direct sales and products to be sold through bank premium vendors and reps. Some popular financial products such as Timex, Oneida, and Corning Ware are normally sold only through distributorships (because these manufacturers offer no return privileges). Hence, many bank premium vendors and reps buy these products from the bank premium distributor even though he is a competitor.

Bank Premium Vendor--also known as a jobber. Purchases directly from manufacturer's rep (premium or retail, whichever is appropriate) or importer or dealer. He usually sells his products directly to the institution. He does not warehouse but does take title to the goods in that he "owns" them. He purchases a wide variety and large quantity of goods through a wide variety of channels. He has established firm credit and trade relationships with many manufacturers.

Bank Premium Rep--an advertising agency and a premium consultant are also under consideration here. This person is peripherally involved in the business. He will sell a program through a bank premium vendor or bank premium distributor. He does not warehouse. He does not take title to the goods. He has no established credit line. He does not have easy access to the manufacturer or manufacturer's rep. He normally receives a small commission or override from the company he purchases from.

SOURCE: Collado Associates and U.S. Financial Services, Inc.

APPENDIX D

ATES	No. of Congressional Districts	No. of Companies
abama	1	1
rizona	1	1
alifornia	14	20
lorado	2	2
nnecticut	6	30
elaware	1	1
orida	6	8
orgia	1	1
wa	1	2
linois	13	41
diana	3	4
nsas	2	6
ntucky	1	2
uisiana	1	1
ssachusetts	6	7
ryland	3	4
chigan	4	4
nnesota	5	18
ssouri	4	6
braska	1	1
rth Carolina	4	6
w Jersey	7	15
w York	18	54
io	10	15
lahoma	1	1
nnsylvania	9	12
ode Island	2	4
nnessee	3	3
xas	4	6
rginia	3	3
rmont	1	1
sconsin	6	16
st Virginia	2	2
3	146	298

istings from
PSE Directory of Member Companies

CONGRESSIONAL DISTRICT ZIP CODES

ALABAMA

Dist. 6 John H. Buchanan

Kohinoor Diamond Corp.	Birmingham, AL 35203

ARIZONA

Dist. 3 Bob Stump

James M. C. Tighe	Sun City, AZ 85351

CALIFORNIA

Dist. 6 Phillip Burton

Walter W. Cribbens Co., Inc.	San Francisco, CA 94105

Dist. 20 Barry Goldwater, Jr.

Balfour	Thousand Oaks, CA 91320
H. M. Meyer Co.	Malibu, CA 90265

Dist. 22 Carlos J. Moorehead

Bushnell Optical Co.	Pasadena, CA 91107
Premium Marketing Corp.	Burbank, CA 92504

Dist. 23 Anthony C. Beilenson

Lee Arter Corp.	Los Angeles, CA 90016
J. Edelman & Assoc.	Van Nuys, CA 91401
Western International Premiums	Los Angeles, CA 90069

Dist. 24 Henry A. Waxman

J. H. Brown & Co., Inc.	Los Angeles, CA 90005

Dist. 25 Edward R. Roybal

Anchor Hocking Corp.	Los Angeles, CA 90022

Dist. 26 John H. Rousselot

Bushnell Optical Co.	Pasadena, CA 91107
Wham-O Mfg. Co.	San Gabriel, CA 91778

Dist. 27 Robert K. Dornan

Pentel of Amer. Ltd.	torrance, CA 90503

Dist. 28 Julian C. Dixon

American Electric Corp.	Culver City, CA 90230
Lee Arter Corp.	Los Angeles, CA 90016

Dist. 30 George E. Danielson

Anchor Hocking Corp.	Los Angeles, CA 90022

Dist. 32 Glenn M. Anderson

Kenwood Electronics	Carson, CA 90745
Pentel of Amer. Ltd.	Torrance, CA 90503
Pioneer Electronics of America	Long Beach, CA 90810
Spearhead Promotions Lady Leisure Products	Torrance, CA 90503

Dist. 33 Wayne Grisham

Martino Mail Marketing	Whittier, CA 90601

Dist. 39 William E. Dannemeyer

Hunt-Wesson Foods	Fullerton, CA 92634

Dist. 40 Robert E. Badham

Premium Incentives	Santa Ana, CA 92650
The Van Heusen Co.	Cost Mesa, CA 92626

COLORADO

Dist. 4 James P. Johnson

Teledyne Water Pik	Ft. Collins, CO 80521

Dist. 5 Ken Kramer

Graphic Incentives	Colorado Springs, CO 80901

CONNECTICUT

Dist. 1 William R. Cotter

Top Value Enterprise	Hartford, CT 06103

Dist. 2 Christopher J. Dodd

Gerald F. O'Rouke & Assoc.	Ellington, CT 06029
Thermos, Div. of King-Seeley Thermos Co.	Norwich, CT 06360

Dist. 3 Robert N. Giaimo

Hauman Marketing Services	Guilford, CT 06437
A. G. Nolan Sales Associates	Orange, CT 06477
Potential Profits Group	Branford, CT 06405
Stuart C. Smith Assoc.	Hamden, CT 06517

Dist. 4 Stewart B. McKinney

A/D Enterprises	Fairfield, CT 06430
Ashflash Crop.	S. Norwalk, CT 06856
Bridgeport Metal Goods Mfg. Co.	Bridgeport, CT 06605
CCC Book Group	Southport CT 06490
N. Donald Edwards Co.	Stamford, CT 06905
Jepcor International Inc.	Greenwich, CT 06830
Longines-Wittnauer Watch Co.	Stamford, CT 06905
Mail Marketing & Fulfillment Corp.	Westport, CT 06880
The Premium Group	Darien, CT 06820
Sperry Remington	Bridgeport, CT 06602
Timex Corp.	Stamford, CT 06905

Dist. 5 William R. Ratchford

Fosdick Corp.	Meriden, CT 06450
Hamilton Beach, Div. Scowell	Waterbury, CT 06720
International Silver Co.	Meriden, CT 06450
Omaha Steaks Intern'l	Waterbury, CT 06720
R & D Associates	New Canaan, CT 06840
Sentry Pack	Oxford, CT 06483
Sharpless Marketing	New Canaan, CT 06840
Shelton Products	Shelton, CT 06484
Uniroyal, Inc.	Naugatuck, CT 06770

Dist. 6 Anthony Toby Moffett

Creative Financial Concepts Inc.	Milldale, Ct 06467
Seth Thomas Clocks	Thomaston, CT 06787
Stanley Tools	New Britain, CT 06050

DELAWARE

Dist. 1 Thomas B. Evans, Jr.

Bugbee & Associates	Wilmington, DE 19802

FLORIDA

Dist. 5 Richard Kelly

Living Homes Co.	Apopka, FL 32703

Dist. 6 C. W. Young

Lakewood Publications	Clearwater, FL 33516

Dist. 9 Bill Nelson

Tupperware Home Parties	Orlando, FL 32802

Dist. 10 L. A. Bafalis (Skip)

George Fearnought	Stuart, FL 33494

Dist. 11 Dan Mica

Neil S. Rowe	Boca Raton, FL 33433
Charles A. Strees & Assoc.	Deerfield Beach, FL 33441

Dist. 13 William Lehman

Manhattan Shirt co.	N. Miami Beach, FL 33179
Tasco Sales	Miami, FL 33138

GEORGIA

Dist. 4 Elliott Levitas

Scripto, Inc.	Doraville, GA 30362

IOWA

Dist. 4 Neal Smith

Better Homes & Gardens Books	Des Moines, IA 50336
The Vernon Company	Newton, IA 50208

ILLINOIS

Dist. 4 Edward J. Derwinski

Continental Premium Co.	Westchester, IL 60153
Continental Scale Co.	Bridgeview, IL 60455

Dist. 5 John G. Fary

Pfaelzer Bros.	Chicago, IL 60632

Dist. 6 Henry J. Hyde

Ansco Photo-Optical Products Corp.	Elke Grove Village, IL 60007
Beeline Fashions	Bensenville, IL 60106
Continental Premium Co.	Westchester, IL 60153
Ekco Houseware Co.	Franklin Park, IL 60131
Nat'l Premium Shour, Inc.	River Forrest, IL 60305
Promotion Plus	Chicago, IL 60656

Dist. 7 Cordiss Collins

Encyclopedia Britannica	Chicago, IL 60611
G.R.I. Corp.	Chicago, IL 60601
Incentive Marketing	Chicago, IL 60601
Phillips Time Corp.	Chicago, IL 60611
Rogers Merchandising Inc.	Chicago, IL 60606
Sales Marketing Mgmt. Magazine	Chicago, IL 60601

Dist. 8 Dan R. Rostenkowski

Borg-Erickson Corp.	Chicago, IL 60651
Incentive Services	Chicago, IL 60641

Dist. 9 Sidney R. Yates

Bell & Howell Co.	Chicago, IL 60645
CM Corp.	Chicago, IL 60610
Premium/Incentive Business Magazine	Chicago, IL 60645
Roberts Incentives	Chicago, IL 60610

Dist. 10 Abner J. Mikva

T. E. Aschenbrener Co.	Northfield, IL 60093
Bell & Howell Co.	Chicago, IL 60645
Brunswick Corp.	Skokie, IL 60076
Jack E. Lau Associates	Northbrook, IL 60062
Newcor, Inc.	Wilmette, IL 60091
E. R. Moore, Co.	Niles, IL 60648
Premium/Incentive Business Magazine	Chicago, IL 60645
Sheaffer-Eaton	Evanston, IL 60201
Skil Corp.	Chicago, IL 60646
Sony Corp. of America	Niles, IL 60648

Dist. 11 Frank Annunzio

Bell & Howell Co.	Chicago, IL 60645
Incentive Services	Chicago, IL 60641
Mar-Son Div. Product Fulfillment, Inc.	Chicago, IL 60641
H. Olsen & Co.	Chicago, IL 60618
Premium/Incentive Business Magazine	Chicago, IL 60645
Promotion Plus	Chicago, IL 60656
Replogle Globes	Chicago, IL 60639
Skil Corp.	Chicago, IL 60646
Sony Corp. of America	Niles, IL 60648

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Dist. 12 Philip M. Crane

Ansco Photo-Optical Products Corp.	Elk Grove Village, IL 60007
Jepcor International	Long Grove, IL 60047
Variety Fare by Beatrice Foods	Elk Grove Village, IL 60007

Dist. 13 Robert McClory

A.M.F. Voit	Lake Forest, IL 60045
Carat Incentives	St. Charles, IL 60174
Quaker Industries	Antioch, IL 60002
Wilson Sporting Goods Co.	River Grove, IL 60171

Dist. 14 John N. Erlenborn

Beeline Fashions, Inc.	Bensenville, IL 60106
Chicago Marketing Systems, Inc.	Schaumburg, IL 60195
Sales Creative Marketing	Oak Brook, IL 60521
Sunbeam Appliance Co.	Oak Brook, IL 60521
Sunbeam Microwave Co.	Oak Brook, IL 60521
Sunbeam Outdoor Co.	Glen Ellyn, IL 60137

Dist. 16 John B. Anderson

The Brearley Co.	Rockford, IL 61105

Dist. 21 Edward R. Madigan

Revere Copper & Brass Co.	Clinton, IL 61727

INDIANA

Dist. 4 Dan Quayle

The Magnovox Co.	Ft. Wayne, IN 46804

Dist. 9 Lee H. Hamilton

Cosco Home Products	Columbus, IN 47201

Dist. 11 Andrew Jacobs, Jr.

The Curtis Publishing Co.	Indianapolis, IN 46202
RCA Sales Corp.	Indianapolis, IN 46201

KANSAS

Dist. 2 James E. Jeffries

Swingster Wearables	Bonner Springs, KS 66012

Dist. 3 Larry Winn, Jr.

Incentive Assoc.	Overland Park, KS 66212
Midland International Corp.	Shawnee Mission, KS 66212
Motivation Services	Lenexa, KS 66219
Premium Associates	Shawnee, KS 66216
Swingster Wearables	Shawnee Mission, KS 66201

KENTUCKY

Dist. 4 Gene Snyder

Lee Leonard Co., Inc.	Ft. Mitchell, KY 41011
Rushland, Inc.	Bedford, KY 40006

LOUISIANA

Dist. 6 W. Henson Moore

H. J. Wilson Co., Inc.	Baton Rouge, LA 70896

MASSACHUSETTS

Dist. 1 Silvio O. Conte

Ken Warren Associates	Westfield, MA 01085

Dist. 4 Robert F. Drinan

Speare and Associates	Weston, MA 02193

Dist. 7 Edward J. Markey

Hobby Marketing Inc.	Walburn, MA 01801
Nat'l Prize Merchandising	Somerville, MA 02143

Dist. 10 Margaret M. Heckler

The Gillitte Company	Boston, MA 02199

Dist. 11 Brian J. Donnelly

Etonic/Ram/Bancroft	Brockton, MA 02403

Dist. 12 Gerry E. Studds

George H. Kramer	Centerville, MA 02632

MARYLAND

Dist. 1 Robert E. Bauman

Nationwide Fulfillment Systems	Chester, MD 21619

Dist. 2	Clarence D. Long
Black & Decker Mfg. Co.	Towson, MD 21204
Dist. 7	Parren J. Mitchell
The Baltimore Luggage Co.	Baltimore, MD 21223
Hedwin Corp.	Baltimore, MD 21211

MICHIGAN

Dist. 4	Dave Stockman
Whirlpool Corp.	Benton Harbor, MI 49022
Dist. 5	Harold S. Sawyer
Bissell, Inc.	Grand Rapids, MI 49501
Dist. 16	John D. Dingell
Winston's Inc.	Dearborn, MI 48126
Dist. 19	William S. Broomfield
American Marketing Headquarters	Birmingham, MI 48010

MINNESOTA

Dist. 1	Arlen Erdahl
Fairbault Wollen Mills Co.	Fairbault, MN 55021
Dist. 2	Tom Hagedorn
The Brothers Jurewicz	Burnsville, MN 55337
Young America Corp.	Young America, MN 55397
Dist. 3	Bill Frenzel
Beakey Lewis & Co., Inc.	Minneapolis, MN 55441
Buchnan, Inc.	Minneapolis, MN 55420
Carlson Marketing & Motivation	Minneapolis, MN 55441
Financial Marketing	Minneapolis, MN 55441
Johnson & Rauch, Inc.	Minneapolis, MN 55416
Minnesota Motivation	Minnetonka, MN 55343
Nordic Ware	Minneapolis, MN 55416
Performance Incentives	Minneapolis, MN 55441
Radde & Kaiser Sales	Hopkins, MN 55343

	Dist. 4 Bruce F. Vento
Fotorama, Inc.	St. Paul, MN 55113
Spotts International	St. Paul, MN 55112
	Dist. 5 Martin Olav Sabo
Paul Gabler Sales Co.	Minneapolis, MN 55418
Honeywell, Inc.	Minneapolis, MN 55408
Litton Microwave Cooking	Minneapolis, MN 55440
Potentials In Marketing	Minneapolis, MN 55403
	MISSOURI
	Dist. 2 Robert A. Young
Anchor Products Co.	St. Louis, MO 63132
Premium Associates	St. Louis, MO 63132
	Dist. 4 Ike N. Skelton
George C. Matteson Co.	Independence, MO 64056
	Dist. 5 Richard Bolling
King Louie Int'l Inc.	Kansas City, MO 64114
	Dist. 8 Richard H. Ichord
Hazel	Washington, MO 63090
McGraw-Edison Co.	columbia, MO 65201
	NORTH CAROLINA
	Dist. 5 Stephen L. Neal
R. J. Reynolds Tobacco Co.	Winston-Salem, NC 27102
	Dist. 6 Richardson Preyer
The Alderman Co.	High Point, NC 27261
Chaseline Div. Chase Bag Co.	Riedsville, NC 27410
	Dist. 9 James G. Martin
Phillip R. Anoff & Assoc., Inc.	Charlotte, NC 28234
	Dist. 11 Lamar Gudger
A-B Emblem	Weaverville, NC 28787
Atex/U.S.A. Inc.	Asheville, NC 28802

NEBRASKA

Dist. 2 John J. Cavanaugh

Rickes Crisa Corp.	Omaha, NB 68102

NEW JERSEY

Dist. 4 Frank Thompson, Jr.

Lenox China, Inc.	Lawrenceville, NJ 08648
PDP Sports Co.	Cranbury, NJ 08512

Dist. 5 Millicent Fenwick

Citadel Industries	Middlesex, NJ 08846
Robert F. Sanford Co.	Mountain Lakes, NJ 07046
Warner-Lambert Co.	Morris Plains, NJ 07950

Dist. 6 Edwin B. Forsythe

Fisher Bruce Co.	Mt. Laurel, NJ 08054

Dist. 7 Andrew Maguire

Marketing Techniques, Inc.	Hackensack, NJ 07602
Minolta Corp.	Ramsey, NJ 07446
Springfield Instruments	Hackensack, NJ 07602

Dist. 9 Harold C. Hollenbeck

General Electric Co.	Englewood Cliffs, NJ 07632
Lasermotion, Inc.	Englewood Cliffs, NJ 07632

Dist. 11 Joseph G. Minish

Casio, Inc.	Fairfield, NJ 07006
Friedin Co.	West Orange, NJ 07052
Hammond, Inc.	Maplewood, NJ 07040

Dist. 15 Edward J. Patten

PDP Sports Co.	Cranbury, NJ 08512
Spalding Sales Corp.	Edison, NJ 08817

NEW YORK

Dist. 1 William Carney

Bishop-Hayden Advertising	Smithtown, NY 11787
Motobecane America Ltd.	Smithtown, NY 11787

	Dist. 3 Jerome A. Ambro
Universal Incentives	Massapequa, NY 11758
	Dist. 4 Norman F. Lent
Helena Rubinstein Inc.	Greenvale, NY 11548
	Dist. 5 John W. Wydler
Advertising Distributors of America	Garden City, NY 11530
Imprint Products	Rockville Centre, NY 11570
	Dist. 6 Lester L. Wolff
Thalheim Exposition Management Corp.	Great Neck, NY 11021
	Dist. 9 Geraldine A. Ferraro
Sony Corp. of America	Long Island City, NY 11101
	Dist. 10 Mario Biaggi
Bulova Watch Co.	Jackson Heights, NY 11370
	Dist. 15 Leo C. Zeferetti
DuBarry Fifth Avenue, Inc.	Brooklyn, NY 11232
	Dist. 17 John M. Murphy
Shaw Creations	New York, NY 10011
	Dist. 18 S. William Green
Advertising Age Magazine	New York, NY 10017
Al Carlisle & Associates	New York, NY 10016
Avon Products, Inc.	New York, NY 10019
Bates Fabric, Inc.	New York, NY 10018
Beacon Manufacturing Co.	New York, NY 10017
The Benjamin Co., Inc.	New York, NY 10022
Russ Berrie & Co.	New York, NY 10010
Business Week	New York, NY 10020
Creative Incentives	New York, NY 10017
Crown Crafts Home Furnishings	New York, NY 10016
Fieldcrest Mills Inc.	New York, NY 10018
Gallagher Bros. Inc.	New York, NY 10001
Harris Enterprise	New York, NY 10017
Helbros Watches	New York, NY 10016
R. A. Holstein Co.	new York, NY 10010
Imperial Knofe Association	New York, NY 10019
Incentive Marketing	New York, NY 10017
William Lambert Marketing Services	New York, NY 10022

Dist. 18 (cont.)	S. William Green
Leathersmith of London, Ltd.	New York, NY 10018
Lees/Keystone Inc.	New York, NY 10010
Mraden-Kane, Inc.	New York, NY 10019
Marketing Communications	New York, NY 10016
Rand McNally & Co.	New York, NY 10022
React Enterprises	New York, NY 10017
North American Phillips Corp.	New York, NY 10017
Olivetti Corp. of America	New York, NY 10022
Palm Beach Co.	New York, NY 10019
Premium Incentive Business Magazine	New York, NY 10036
Sales & Marketing Management Magazine	New York, NY 10017
Seiko Time Corp.	New York, NY 10019
Sony Corp. of America	New York, NY 10019
Toshiba America	New York, NY 10017
Van Heusen Co.	New York, NY 10019
Union Carbide Corp.	New York, NY 10017
Dist. 20	Theodore S. Weiss
Artcarved, Inc.	New York, NY 10001
Bostonian Shoes	New York, NY 10001
Premium Incentive Business Magazine	New York, NY 10036
Dist. 24	Richard L. Ottinger
Commercail Decal Inc.	Mt. Vernon, NY 10550
Dist. 25	Hamilton Fish, Jr.
Mainline Representatives, Inc.	Scarsdale, NY 10587
Dist. 26	Benjamin A. Gilman
Kennedy Mint	Suffern, NY 10901
Dist. 32	James M. Hanley
Oneida Silversmiths	Oneida, NY 13421
Oneida, Ltd.	Oneida, NY 13421
Dist. 34	Frank Horton
McManus & Associates	Fairport, NY 14450
Sarah Coventry, Inc.	Newark, NY 14593

	Dist. 35 Barber B. Conable, Jr.
Eastman Kodak Co.	Rochester, NY 14650
	Dist. 39 Stanley N. Lundine
Corning Glass Works	Corning, NY 14830
	OHIO
	Dist. 1 Willis D. Gradison, Jr.
Ohio Specialty Sales Co.	Cincinnati, OH 45227
	Dist. 3 Tony P. Hall
Top Value Enterprises	Dayton, OH 45459
	Dist. 6 William H. Harsha
Rubbermaid Sales Corp.	Chillicothe, OH 45601
Wear-Ever Aluminum	Chillicothe, OH 45601
	Dist. 10 Clarence E. Miller
Anchor Hocking Co.	Lancaster, OH 43130
	Dist. 13 Donald J. Pease
Pardick-Bennet Co.	Medina, Oh 44256
	Dist. 16 Ralph S. Regula
The Hoover Co.	North Canton, OH 44720
White Engines	Canton, OH 44707
	Dist. 17 John M. Ashbrook
Rawlings Golf	Granville, OH 43023
The Toppen Co.	Mansfield, OH 44901
	Dist. 20 Mary Rose Oakar
The Kennedy Mint	Cleveland, OH 44142
	Dist. 21 Louis Stokes
True Temper Corp.	Cleveland, OH 44115
	Dist. 22 Charles A. Vanik
Motivation Representatives	Cleveland, OH 44118
Unicorn Sales Co.	Chagrin Falls, OH 44022
	District Unknown
Libbey Glass	Toledo, OH 43693

OKLAHOMA

Dist. 2 Michael Lynn Synar

Barlett-Collins Co.	Sapulpa, OK 74066

PENNSYLVANIA

Dist. 2 William H. Gray

Promotion Motivation Assoc.	Philadelphia, Pa 19118

Dist. 5 Robert T. Schulze

Thomas J. Murphy Co.	Havertown, PA 19083

Dist. 8 Peter H. Kostmayer

W. M. Dalton Assoc.	Newtown, PA 18940

Dist. 13 Lawrence Coughlin

Proctor-Silex	King of Prussia, PA 19406
Sales Aides International	Jenkintown, PA 19046

Dist. 15 Donald Lawrence Ritter

Lutron Electronics	Coopersburg, PA 18036

Dist. 16 Robert S. Walker

Hamilton Watch Co.	Lancaster, Pa 17604

Dist. 18 Doug Walgren

J. Edward Connelly Associates	Pittsburgh, PA 15220
Olsen-O'Leary Associates, Inc.	Pittsburgh, PA 15238

Dist. 19 William F. Goodling

The Hanover Shoe, Inc.	Hanover, PA 17331
Yorkcraft, Inc.	York, PA 17405

Dist. 21 Don Bailey

Jeanette Corp.	Jeanette, PA 15644

RHODE ISLAND

Dist. 1 Fernand J. St. Germain

American Tourister, Inc.	Warren, RI 02885

Dist. 2 Edward P. Beard

L. Gordon McCoy	Warwick, RI 02889
J. J. Mfg. Co., Inc.	Providence, RI 02909
Keitzner Ind. Providence Emblem Co.	Providence, RI 02901

TENNESSEE

Dist. 5 William Hill Boner

Nasco, Inc.	Springfield, TN 37172

Dist. 6 Robert L. Beard

Quality Stamp Co. Inc.	Memphis, TN 38118

Dist. 7 Ed Jones

Worldwide ARt Studios	Covington, TN 38019

TEXAS

Dist. 4 Ray Roberts

Smoker Products, Inc.	Mabank, TX 75147

Dist. 5 Jim Mattox

Dallas Cap & Emblem Mfg., Inc.	Dallas, TX 75226
Ted House, Inc.	Dallas, TX 75242

Dist. 7 Bill Archer

Weed Eater, Inc.	Houston, TX 77036

Dist. 18 George Thomas Leland

Gulf Cons. Svc. Co. Gulf Auto Clubs	Houston, TX 77001

VIRGINIA

Dist. 3 David E. Satterfield III

Nappe/Babcock, Div. of Dart Ind.	Richmond, VA 23216

Dist. 6 M. Caldwell Butler

Marketing Consultants	Roanoke, VA 24014

Dist. 10 Joseph L. Fisher

LAND Industries	Arlington, VA 22206

VERMONT

Dist. 1 James M. Jeffords

Creative Took, Inc.	Bennington, VT 05201

WISCONSIN

Dist. 1 Les Aspin

John L. Chaney Instrument Co.	Lake Geneva, WI 53147
Johnson Wax Assoc.	Racine WI 53402
Parker Pen Co.	Janesville, WI 53545

Dist. 2 Robert W. Kastenmeier

Flambeau Products Corp.	Baraboo, WI 53913
Ray-O-Vac	Madison, WI 53703
Sales Motivators, Inc.	Baraboo, WI 53913

Dist. 3 Alvin Baldus

Nat'l Presto Industries	Eau Claire, WI 54701

Dist. 5 Henry S. Reuss

K-Promotions, Inc.	Milwaukee, WI 53209
Schlitz Brewing Co.	Milwaukee, WI 53201

Dist. 6 VACANT

Mirro Aluminum Co.	Manitowoc, WI 54220
William W. Schwartz Associates	Sheboygan, WI 53081
Top Brands, Inc.	Oshkosh, WI 54901

Dist. 9 F. James Sensenbrenner, Jr.

Oster Corp.	Milwaukee, WI 53217
Regal Ware, Inc.	Kewaskum, WI 53040
Rewards, Inc.	West Bend, WI 53095
The West Bend Co.	West Bend, WI 53095

WEST VIRGINIA

Dist. 1 Robert H. Mollohan

McDonough Incentive	Parkersburg, WV 26101

Dist. 3 John M. Slack

Bright of America	Summerville, WV 26651

SOURCE: National Premium Sales Executives

NOTES

1/ The results of the Rubin survey are presented in his June 17, 1980, letter to Normand R.V. Bernard, Depository Institutions Deregulation Committee.

2/ Letter dated April 28, 1971, from Larry O. Edwards, Lincoln Rochester Trust Company, to Representative Wright Patman, Chairman, House Banking Committee with respect to Banking Reform Act of 1971 (H.R. 5700 - 92nd Cong.)

3/ Testimony of Nathaniel R. Bowditch, Vice Chairman of First Pennsylvania Bank, N.A. before the Senate Select Committee on Small Business, July 1975.

4/ Note particularly Incentive Marketing, Vol.150, No.4, April, 1980, PP.80-120.

5/ "How the Use of Premium Advertising Benefits Financial Institutions Throughout the United States." Premium/Incentive Business Magazine (Prepared for the Premium Coordinating Committee), June 1, 1980.

6/ A.B.A. 1968 Advertising Survey, American Bankers Association, New York, 1969.

7/ Unidex Corporation. Premiums - Three Year Up-Date. Marketlink Phoenix, Ariz., February 1980. The survey in question 5 compares 1980 responses with those from a 1977 survey in which 97 percent responded favorably (55 percent in the "very successful" category and 42 percent in the "moderately successful" group). No explanation for the changes in the subtotals is afforded.

8/ Ibid., Question six.

9/ P/IB June Survey, op.cit.,p.2.

10/ IM, April 1980, p.81.

11/ P/IB June Survey p.3.

12/ Ibid., p.1, These figures doubtless understate current spending as a result of recent actions permitting state chartered banks to use premiums beyond branch openings.

13/ Unidex Corp., Feb. 1980.

14/
"The Incentive Market: 1979 Facts Issue." Incentive Marketing, Vol.148, No.6, December 1979, p.13.

15/
Ibid.,p.34. The $146.9 million estimated expenditure by depository institutions in 1978 was augmented by the 13.3 percent growth factor that Incentive Marketing used to estimate 1979 total premium expenditures. Based on historical trends and current industry calculations, the growth factor was probably closer to 20 percent and the 1979 expenditure figure was approximately $175 million.

16/
Ibid., p. 87.

17/
Ibid., pp. 34 and 87. The use of the category "direct premiums" in the Incentive Marketing survey appears to correspond only in part with the term "free gift" used in the financial industry. It is difficult to judge whether that survey has painstakenly isolated "free gifts" which are used in most, if not all, types of premium programs, including self-liquidating programs.

18/
PI/B June Survey, op. cit., p. 5.

19/
Ibid.

20/
ABA Survey, op. cit. Results summarized in Customer Premiums -- How To Use Them As a Bank Marketing Tool, American Bankers Association, New York, 1970.

21/
Ibid.

22/
Incentive Marketing estimates that "(a)bout 60 percent (of the 21,000 financial institutions in the U.S.) use premiums at least once a year." (IM, Vol.150, No. 4, April 1980, p. 80) That figure -- some 12,600 institutions -- is out of proportion with industry experience and produces an understated average premium expenditure of slightly more than $10,000 per institution.

23/
Howard A. Rubin, Letter addressed to Mr. Normand R.V. Bernard, Depository Institutions Deregulation Committee, dated June 17, 1980, p.2.

24/ Applying this same approach to the $476 million figure developed by *Premium/Incentive Business* would yield apparently exaggerated estimates for premium sales of $809 million to $1,285 million.

25/ Breakdown for rest of New York state not available at the time of publication.

26/ Rubin letter, *op. cit*.

27/ The premium cost of $2 for every $1000 deposited represents an average cost. Vendors normally tell their banking clients that the cost will range from $1 to $3 per $1000 of deposits. Actual experience varies even more widely depending on macroeconomic factors and whether the bank plans to be conservative and recoup most of its premium costs or aggressive and absorb much of those costs. Specific calculations of several "conservative" campaigns are described below in this report.

28/ Bowditch, in his 1975 testimony before the Senate Select Committee on Small Business, described a branch opening in South Philadelphia that reportedly would have drawn 25 new accounts each week -- an unacceptably unprofitable rate at which to inaugurate the branch. Using premiums, his bank was able to obtain 30,000 new accounts and $84 million over a 12-week period.

29/ Unidex Corporation, *Premiums -- Eight Year Comparison*, Phoenix, Arizona, January 1980, Question 2.

30/ *Ibid*.

31/ *Viz*. Lincoln Rochester Trust Co. letter cited in footnote 12; Harley H. Hinrichs, *An Analysis of Bank Customer Premiums: The Case For Preservation With Regulation*, U.S. Naval Academy, Annapolis, Md., undated manuscript, pp.5-6.

32/ F. Robert Dwyer, RobertH. Preston and William Rudelius, *Stoneware...Calculators...and Mercedes Benz Coupes -- on the Effectiveness of Bank Premiums*. Center for

Experimental Studies in Business, University of Minnesota, Minneapolis, Minn., January 1977.

33/ Based on the analysis, the authors suggested that "on average about one person in seven might be engaging in premium-seeking gamesmanship." This figure, derived under controlled conditions, greatly exceeds an average estimate of 3-5 percent "premium jumpers" among bankers interviewed by Collado Associates. Moreover, the Minnesota study compared retention rates over a six-month period while most banks interviewed tended to evaluate their deposits over six-, nine- and 12-month periods.

34/ Ibid., p. 21.

35/ Ibid., pp. 21-22.

36/ Ibid., p. 6.

37/ Larry O. Edwards, A Recommendation For Federal Legislation on Bank Use of Merchandise Premiums For Deposit Growth. Stonier Graduate School of Banking, New Brunswick, New Jersey, March 1972, p. 78.

38/ Ibid.

39/ Quoted in ibid., pp. 69-70.

40/ Legal Division, Board of Governors, Federal Reserve Board, Merchandise Promotion Activities of Member Banks. Statement before Senate Select Committee on Small Business, July 16, 1975.

41/ Ibid.

42/ Ibid.

43/ Cited in Hinrichs. op. cit., pp. 4-5.

44/ Edwards, op. cit., p.17.

45/ Unidex Corporation, op. cit., January 1980, p.6a.

46/ Robert P. Fried, Consumer Impact of Premium Promotion Campaigns in Financial Institutions. St. John's University, New York, 1974, pp. 5-6.

47/ Data for the Far West were unavailable broken down by individual vendor sales. Thus the $403.8 million total must be reduced $30.0 million in order to make the calculation for bank premium sales by percentage of bank to total market sales.

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